

UNITED STATES BANKRUPTCY COURT
DISTRICT OF SOUTH DAKOTA

In re:) Bankr. No. 03-10194
) Chapter 7
TRI-STATE ETHANOL COMPANY LLC)
) AMENDED MEMORANDUM RE:
Debtor.) SEVERAL PENDING MATTERS

An objection to proofs of claim and several motions, all but one of which are related, are before the Court:

- (1) *Objection to Claim of Woods, Fuller, Schultz and Smith, P.C.* filed by Tri-State Financial, L.L.C., on December 14, 2006 and the response thereto filed by Woods, Fuller, Schultz & Smith P.C. on January 23, 2007;
- (2) *Second Interim Application for Allowance of Compensation and Reimbursement of Expenses* filed by Woods, Fuller, Schultz & Smith P.C. on January 26, 2007 and the response thereto filed by Tri-State Financial, L.L.C. on February 20, 2007;
- (3) *Motion to Strike and for Protective Order* filed by Woods, Fuller, Schultz & Smith P.C. on February 20, 2007 and the response thereto filed by Tri-State Financial, L.L.C., on March 2, 2007 and the attendant briefs;
- (4) *Motion to Compel Woods, Fuller, Schultz and Smith, P.C. to Make Discovery* filed by Tri-State Financial, L.L.C., on March 2, 2007 and the response and brief filed by Woods, Fuller, Schultz & Smith P.C. on March 16, 2007;
- (5) *Nonstandard Motion for Disclosure of Sealed Transcript* filed by Woods, Fuller, Schultz & Smith P.C. on March 6, 2007 and the response thereto filed by Tri-State Financial, L.L.C., on March 7, 2007;
- (6) *Motion for Reconsideration of Order Granting Tri-State Financial, LLC's Motion to Substitute Counsel, and Objection to Tri-State Financial, LLC's Motion to Substitute Counsel* filed by Trustee John S. Lovald on March 16, 2007 and the amended response thereto filed by Tri-State Financial, L.L.C., on March 26, 2007;
- (7) *Motion for Hearing on Discovery Issues and for Continuance of Evidentiary Hearing* filed by Tri-State Financial, L.L.C., on April 6, 2007; and

(8) *Motion to Disqualify Woods, Fuller, Schultz & Smith as Attorneys for Trustee* filed by Tri-State Financial, L.L.C., on April 6, 2007.

Each is a core matter under 28 U.S.C. § 157(b)(2). This Memorandum and attendant orders constitute the Court's interim findings and conclusions on these pending matters under Fed.Rs.Bankr.P. 7052 and 9014(c), some interim and some final.

I.

SUMMARY OF PENDING MATTERS AND RELATED FACTS.

Tri-State Ethanol Company, L.L.C., ("Debtor") filed a Chapter 11 petition in bankruptcy on May 23, 2003. Debtor filed an application on August 1, 2003 to employ Woods, Fuller, Schultz & Smith P.C. ("Woods Fuller") as special counsel. According to the application, Woods Fuller was to represent Debtor in "various litigation, both as Plaintiff and Defendant involved with the construction of Debtor's [ethanol plant]...." The application also stated,

Even though William G. Taylor and the firm of Woods Fuller are shown on Schedule F as a creditor in the amount of \$79,924.05, that claim represented their efforts on behalf of the Debtor pre-bankruptcy concerning the construction of the ethanol plant. While technically that claim would disqualify a firm from post-filing representation, the Debtor believes that their experience, involvement in these cases, and pre-bankruptcy representation would allow them to more efficiently and effectively represent the Debtor post-bankruptcy to this limited extent.

No objections were filed, and the application was approved.

Tri-State Financial, L.L.C. ("Tri-State Financial"), an entity that had been formed post-petition to aid Debtor in its proposed Chapter 11 reorganization and which apparently acquired an ownership interest in Debtor,¹ made its first formal appearance in the case through counsel on March 8, 2004. Its out of state attorney was admitted *pro hac vice* on June 18, 2004.

On May 25, 2004, Woods Fuller filed a proof of claim against the Chapter 11 estate for its pre-petition legal services rendered for Debtor. It sought, as a general unsecured claim "\$168,000.00 plus accrued interest in an amount to be determined."

Only one insurance-related matter and a few claims were fully and finally resolved while Debtor was in Chapter 11. A plan was never confirmed. The case was converted to Chapter 7 on July 29, 2004. John S. Lovald was selected by the United States Trustee to serve as the case trustee.

On January 24, 2005, Woods Fuller filed a proof for a priority claim of \$61,242.84. This proof of claim did not indicate it was an amendment or replacement for the May 25, 2004 proof of claim. On January 24, 2005, Woods Fuller also filed a fee application for services rendered for Debtor from May 27, 2003 through January 10,

¹ Tri-State Financial has stated in various pleadings and briefs it presently owns a 40% interest in Debtor. The Court has never formally received documentation related to this ownership interest or when and how it was acquired by Tri-State Financial.

2005. The sum sought was \$61,242.84. Objections were filed by North Central and the United States Trustee. At the hearing, the parties reported a settlement, which the Court took under advisement. Woods Fuller subsequently argued North Central did not have standing to object. The Court ruled North Central did not have standing and accepted the proposed resolution of the United States Trustee's objections. The resolution included Woods Fuller's withdrawing its application for fees incurred post-conversion. Woods Fuller filed a § 329(b) disclosure of compensation on March 1, 2005 indicating its pre-petition fees were about \$168,000.00. Woods Fuller also obtained on April 25, 2005 court approval of its request that the Chapter 11 order employing them be made retroactive to the petition date, which resolved one of the United States Trustee's objections to its fee application. The agreed fee order was entered May 5, 2005.

On February 5, 2005, Trustee Lovald sold the bankruptcy estate's ethanol plant to Tri-State Financial. Some claims were paid shortly thereafter with court approval. Since then, progress in the case has been limited, and resolution of the remaining claims has been an arduous process.

On April 22, 2005, Trustee Lovald filed under 11 U.S.C. § 327(e) an application to employ Woods Fuller as Chapter 7 special counsel.

The scope of the representation [will include] pending and future litigation, including adversary proceedings, contested matters, trials, appeals, hearings, mediation, arbitration, whether inside or outside the bankruptcy forum, as the situation may ultimately dictate, regarding any issues related to the design and construction of the debtor's ethanol plant, or explosion at the plant, including but not limited to issues between the Trustee and North Central Construction, now known as American Prairie Construction Company..., and Gaylor Engineering[.]

This application also acknowledged Woods Fuller's claim against the estate for pre-petition fees and acknowledged the claim rendered Woods Fuller not disinterested but still employable under 11 U.S.C. § 327(e). No objections to this employment application were filed, and it was approved by order entered May 5, 2005.

On May 17, 2005, Trustee Lovald reached a settlement with Tri-State Financial, which had filed both an administrative claim and an unsecured claim for \$1,983,654.42 representing post-petition loans made to Debtor², and an equity interest claim for \$2,500,000.00. Before an evidentiary hearing on the settlement with Tri-State Financial was held, Trustee Lovald and several large claim holders in the case reached a more global settlement through mediation. Following an evidentiary hearing, the Court denied approval of the more global settlement by order entered May 5, 2006. Accordingly, the original settlement with Tri-State

² These loans were not court-approved with the exception of one for \$25,105.65.

Financial was back on the table. The sole objection to that settlement was withdrawn, and Trustee Lovald's settlement with Tri-State Financial was approved by order entered June 14, 2006. That order is final.

Trustee Lovald obtained court approval of his settlements of several other claims. Some were contested; others were not. His approved settlement with Murphy Brothers is presently on appeal to the United States District Court for the District of South Dakota, case no. 1:07-cv-01033-CBK.

Trustee Lovald has also proposed a settlement with North Central Construction. The only objector to this proposed settlement was Tri-State Financial, whose objection was filed July 12, 2006. Among its many claimed bases for the objection, Tri-State Financial argued Trustee Lovald had failed to "exercise reasonable diligence [in acquiring] information sufficient to determine whether the proposed compromise was reasonable, in the best interest of the bankruptcy estate, and fair and equitable[.]" It also argued Trustee Lovald had abandoned the interests of the equity security holders in Debtor and had not adequately represented their interests. In its pre-trial brief filed December 13, 2006, Tri-State Financial argued

[i]n the [settlement] process [Trustee] Lovald - and his attorney [William G.] Taylor [of Woods Fuller] - have also completely flipflopped from the advice that his attorney, Taylor, had given to [Debtor] before [Debtor] filed Chapter

11. This advice included that [Debtor] and its members had defenses to owing [North Central] no more than the \$8,749,270.72 that [Debtor] had already paid. Taylor's advice to [Debtor] also included filing a counterclaim for the faulty defective performance of [North Central] and for Buchanan's³ breach of fiduciary duty.

An evidentiary hearing on the trustee's proposed settlement with North Central was held December 18-20, 2006, and the matter was taken under advisement. It is still pending.

Shortly before the evidentiary hearing on the North Central settlement, Tri-State Financial filed an objection to Woods Fuller's proofs of claim. Tri-State Financial argued Debtor and Woods Fuller did not have a written employment agreement and no part of either claim had been approved by Debtor's governing board. In its subsequent brief, Tri-State Financial also complained Woods Fuller's legal services were worth substantially less than the \$229,242.24 sought, stating:

Such services provided advice to [Debtor] which is the direct opposite of advice [Woods Fuller] has, on information and belief, provided to the Trustee. For example, Bill Taylor of [Woods Fuller] encouraged [Debtor] not to settle with [North Central] at any sum based on previous experience with [North Central], their contracts, change orders, and other documents he had reviewed. Taylor told [Debtor] they would not owe anything to [North Central] by the time he got done with them. Taylor also said that [North Central's] president, Kim Buchanan, had breached his fiduciary duty to [Debtor] while he was on the Board of Managers of [Debtor] and

³ In this brief, Tri-State Financial described Kim Buchanan as the owner, chief executive, and president of North Central and a one-time member of Debtor's board of managers.

while he was president of the Board of Managers of [Debtor]. Taylor also said that a counterclaim by [Debtor] against [North Central] would be appropriate because the plant did not work. [Debtor] agreed to have [Woods Fuller] engaged by Trustee Lovald because of their confidence and trust in [Woods Fuller] to follow through on the advice given to [Debtor] concerning [North Central]. However, once hired by Lovald, [Woods Fuller]'s advice has been the opposite - to pay [North Central] \$2 million or more. On information and belief, [Woods Fuller] has not advised Lovald regarding [North Central]'s breach of fiduciary duty or the counterclaim against [North Central].

On January 26, 2007, Woods Fuller filed its second fee application for services rendered and expenses incurred from December 5, 2005 through December 7, 2006. The total sought was \$160,887.87, which includes \$147,534.00 for professional services, expenses of \$4,619.86, and sales tax of \$8,734.01. The only objector to this fee application was Tri-State Financial. Tri-State Financial argued:

In the representation of the Trustee, [Woods Fuller] provided advice and services to the Trustee that are contrary to and in conflict with the advice and services that [Woods Fuller] had provided to [Tri-State Ethanol Co., L.L.C.] as debtor and debtor-in-possession before and after the commencement of this case on 5/23/03.

To a large extent, the professional services of [Woods Fuller] were misdirected, often at [Tri-State Financial], and not focused on enhancing the estate for the benefit of creditors and holders of equity security interests. To a significant extent, but not exclusively, on account of this, the aggregate fees to date and the fees claimed in [Woods Fuller]'s Second Application for Fees and Expenses are unreasonable and excessive, the hours spent are unreasonable, unnecessary, and may sometimes be duplicative, and professional services for which the fees are claimed have often not benefitted the

Chapter 7 estate. The efforts of [Woods Fuller] on major problems such as the claim of North Central Construction, Inc. ... and Gaylor Engineering...have not enhanced the Chapter 7 estate, reduced unsupportable claims against the Chapter 7 estate, or, in other words, resulted in a sufficiently high degree of success so as to be commensurate with the amount of fees. Litigation was not brought at all or not timely brought by the Trustee against [North Central] or Gaylor. No objections to the claim of [North Central] identifying the Chapter 7 estate's defenses and/or counterclaims was ever filed by [Woods Fuller] on behalf of the Trustee and appropriate litigation was either never commenced ([North Central] and others) or not timely commenced (Gaylor Engineering). The litigation against Gaylor was belatedly filed by the Trustee and has appeared to encounter the defense by Gaylor that the litigation should be dismissed for failure to timely prosecute. Results commensurate with the fees have not been and are not identified in [Woods Fuller]'s Second Application for Fees and Expenses.

[Paragraph numbers omitted.] Tri-State Financial alternatively argued Woods Fuller's second fee application "is premature before the results of and by [the law firm] are known."

Evidentiary hearings on Tri-State Financial's objection to Woods Fuller's proofs of claim and its objection to Woods Fuller's second fee application are scheduled for April 26, 2007. Discovery was ordered to be completed by April 9, 2007. Parties were directed to file their respective Witness and Exhibit Lists by April 20, 2007, and pre-hearing briefs are due April 20, 2007. Both contested matters have spawned several other motions and objections.

On February 20, 2007, Woods Fuller moved to strike several of Tri-State Financial's discovery requests made upon it and upon

Trustee Lovald. Woods Fuller argued much of the discovery requested by Tri-State Financial had already been provided as part of the discovery related to Trustee Lovald's motion to approve the settlement with North Central and some had already been deemed privileged during the hearing on that proposed settlement. Woods Fuller further argued some of the discovery requests were not relevant to the fee matters at hand. Tri-State Financial filed a motion to compel regarding its discovery requests made upon Woods Fuller. Tri-State Financial argued no privilege applied. Tri-State Financial did not clearly address Woods Fuller's allegation that some discovery materials had already been furnished to Tri-State Financial during discovery regarding the trustee's proposed settlement with North Central. Each objected to the other's motion.

Woods Fuller has also requested a copy of the sealed transcript of the *in camera* hearing, held as part of the North Central settlement hearing, during which the Court ruled upon asserted privileges. Tri-State Financial responded saying the sealed transcript is not relevant but if Woods Fuller is given access, it wants access as well.

While these matters were percolating, Tri-State Financial's local counsel, Terry N. Prendergast of Murphy, Goldammer & Prendergast, L.L.P., sought and obtained court authority to

substitute Courtney R. Clayborne of Clayborne, Loos, Strommen & Gusinsky, L.L.P., as local counsel for Tri-State Financial. On March 16, 2007, Trustee Lovald filed a motion asking this Court to reconsider the order. Trustee Lovald said he had pending before the District Court a motion to have Tri-State Financial's out of town counsel's *pro hac vice* status revoked and he did not want the unavailability of experienced local counsel to negatively impact its motion before the District Court. Tri-State Financial responded saying efforts to find new local counsel were unrelated to pending matters before the Bankruptcy Court and District Court, and it argued its right to select its own counsel should not be impeded. In this objection, Tri-State Financial also again took issue with Trustee Lovald's employment of Woods Fuller:

At no time has [Debtor] given written informed consent to [Woods Fuller] to represent the Trustee in conflict with [Debtor]'s interests.

The Trustee in filing the Reconsideration Motion as well as similar motions before [the United States District Court] is aiding and abetting violations by his attorneys [Woods Fuller] of 11 U.S.C. § 27 (e) [sic] and Rules 1.6 and 1.9 of the South Dakota Rules of Professional Responsibility. [Case cites omitted.]

[Paragraph numbers in objection omitted.]

Finally, on April 6, 2007, Tri-State Financial filed two more motions. The first requested a hearing on the pending discovery disputes and a rescheduling of the April 26, 2007 evidentiary

hearings on Woods Fuller's proofs of claim and its second fee application. Tri-State Financial's second motion requested that Woods Fuller be disqualified as counsel for Trustee Lovald. It argued Woods Fuller has never been qualified under 11 U.S.C. § 327(a) to represent the trustee because it was not disinterested. It also argued Woods Fuller had violated or is violating several rules of professional responsibility because it has not given Debtor its undivided loyalty.

Since the employment of [Woods Fuller] by the Trustee for specified special purposes was approved on May 5, 2005, [Woods Fuller] has done a 180 degree turn around from the positions that [Woods Fuller] advocated against [North Central] and Gaylor in representing Debtor. The Debtor still adheres to those positions. The positions that [Woods Fuller] now advocates in representing the Trustee are materially adverse to the unchanged positions of Debtor against [North Central] and Gaylor.

The positions against [North Central] and Gaylor that [Woods Fuller] now advocates in representing the Trustee are based on information that [Woods Fuller] obtained from Debtor in rendering legal advice in confidence before Debtor filed its original position on May 23, 2003. [Woods Fuller], in representing the Trustee, now contends that same information is privileged against the Debtor.

The positions against [North Central] and Gaylor that [Woods Fuller] now asserts in representing the Trustee have a material and adverse impact on the interests of the Debtor and the interests of holders of equity in the Debtor including [Tri-State Financial], a holder of approximately 40% of the equity in the Debtor.

[Woods Fuller] has failed to explain how the same information obtained from the Debtor can be the basis of the positions against [North Central] and Gaylor that

[Woods Fuller] formerly advocated to the Debtor and also be the basis of the opposite positions against [North Central] and Gaylor that [Woods Fuller] now advocates in representing the Trustee.

[Paragraph numbers in motion omitted.] Woods Fuller and Trustee Lovald have not yet responded to these last two motions.

Excluding perhaps the three pending discovery motions, the other pending matters initially present two legal questions, both of which serve as major components of some of Tri-State Financial's pending pleadings. The first is whether Woods Fuller is disqualified from representing the Chapter 7 estate as special counsel regarding the construction-related claims because the law firm holds a claim against the estate for pre-petition services rendered for Debtor. Tri-State Financial argues the law firm is disqualified because it is not disinterested. The second legal issue is whether Woods Fuller may represent Trustee Lovald and the Chapter 7 estate if that representation is contrary to Debtor's and its equity security holder's best interests. Tri-State Financial argues the law firm cannot represent the bankruptcy estate to Debtor's and its equity security holders' detriment. Attendant with these positions taken by Tri-State Financial, it has complained Woods Fuller has "flip flopped" on advice the firm had earlier given Debtor regarding the nature and proposed resolution of North Central's claim. Though Tri-State Financial has offered little or no case law in support for these legal arguments, they

need to be addressed first.

II.

WOODS FULLER'S EMPLOYMENT AND COMPENSATION AS SPECIAL COUNSEL

The employment of special counsel by a bankruptcy estate is governed by 11 U.S.C. § 327(e). This subsection provides:

The trustee, with the court's approval, may employ, for a specified special purpose, other than to represent the trustee in conducting the case, an attorney that has represented the debtor, if in the best interest of the estate, and if such attorney does not represent or hold any interest adverse to the debtor or to the estate with respect to the matter on which such attorney is to be employed.

11 U.S.C. § 327(3)(2003). Under this subsection, three conditions must be met: (1) the attorney to be employed as special counsel must have previously represented the debtor; (2) the hiring of the attorney must be in the best interest of the estate; and (3) the attorney may not hold an interest adverse to the debtor or the estate "with respect to the matter" for which he or she is being employed. *In re NWFx, Inc.*, 267 B.R. 118, 246 (Bankr. W.D. Ark. 2001)(cites therein). As noted in *NWFx*, the subsection will most often be utilized when the debtor "is involved in complex litigation, and changing attorneys in the middle of the case after the bankruptcy case has commenced would be detrimental to the progress of that other litigation." *NWFx*, 267 B.R. at 246 (quoting *In re Abrass*, 250 B.R. 432, 436 (Bankr. M.D. Fla. 2000)

(quoting H.R. Rep. No. 595, 95th Cong., 1st Sess.328 (1977), U.S.Code Cong. & Admin. News 1977, p. 5963; S. Rep. No. 989, 95th Cong., 2d Sess. 38-39 (1978), U.S.Code Cong. & Admin.News 1978, p. 5787)). The subsection is designed to "promote economy in administration" and "avoid wasteful expense and delay that might result from having to hire disinterested counsel unfamiliar with the subject matter." *Buckley v. Transamerica Investment Corp. (In re Southern Kitchens, Inc.)*, 216 B.R. 819, 826 (Bankr. D. Minn. 1998)(citing *In re Bowman*, 181 B.R. 836, 847 (Bankr. D. Md. 1995)).

An attorney employed under § 327(e) may be compensated from the bankruptcy estate pursuant to 11 U.S.C. § 330(a). The fees must be sought by application and notice as required by Fed.Rs.Bankr.P. 2002(a)(6) and 2016(a).

In its objection to Woods Fuller's proof of claim no. 261, its objection to Woods Fuller's second fee application, and its new motion to disqualify the firm as counsel for the Chapter 7 trustee, Tri-State Financial has complained Woods Fuller is not disinterested as required by 11 U.S.C. § 327(a). That subsection of § 327 is not applicable here, however, and neither is that subsection's "disinterested" requirement. Instead, § 327(e) provides the proposed attorney to be employed for a special purpose may "not represent or hold any interest adverse to the debtor or to the estate." While the adverse interest provision of § 327(a)

limits itself to interests adverse to the bankruptcy estate, § 327(e) expands the requirement to interests adverse to the bankruptcy estate or the debtor.

Whether an attorney is "disinterested" depends on the application of the several definitions set forth at 11 U.S.C. § 101(14). The Bankruptcy Code, however, does not define "adverse interest," and so the issue is often more complex. There is no general rule, and "[e]ach case must finally turn on its own circumstances, based on a common-sense divination of adversity or commonality." *Southern Kitchens*, 216 B.R. at 827.

Many courts have applied the definition of "adverse interest" set forth in *In re Roberts*, 46 B.R. 815, 827 (Bankr. D. Utah 1985), *aff'd in relevant part and rev'd and remanded in part on other grounds*, 75 B.R. 402 (D. Utah 1987). Therein, the court defined "hold[ing] an adverse interest to the estate" as "possess[ing] or assert[ing] any economic interest that would tend to lessen the value of the bankruptcy estate or that would create either an actual or potential dispute in which the estate is a rival claimant" or "possess[ing] a predisposition under circumstances that would render such a bias against the estate." *Roberts*, 46 B.R. at 827 (cited with approval in *Pierce v. Aetna Life Ins. Co. (In re Pierce)*, 809 F.2d 1356, 1362 (8th Cir. 1987)). Other courts have stated the "no adverse interest" standard is met if the

special counsel's interests and the estate's interests are identical with respect to the matter for which the attorney was retained. *In re Peters Contracting, Inc.*, 301 B.R. 857, 860-61 (Bankr. M.D. Tenn. 2003)(cites therein). Further, many courts have concluded holding a claim against the estate for fees does not constitute an adverse interest. *See In re EBW Laser, Inc.*, 333 B.R. 351, 352 n.3 (Bankr. M.D.N.C. 2005)(cases cited and discussed therein); *In re Elias*, Bankr. No. 02-41340, 2005 WL 4705220, slip op. at 5 (Bankr. D. Idaho June 10, 2005)(citing *Stoumbos v. Kilimnik*, 988 F.2d 949, 964 (9th Cir. 1993)(special counsel who is also an estate creditor holds a common interest with the estate, not an adverse one, since any money he recovers for the estate will benefit the estate and him)). *Compare Pierce*, 809 F.2d at 1362 (citing decisions that concluded an attorney holds an adverse interest and may not be employed under § 327(e) if the attorney has a mortgage on estate assets or if the attorney fails to disclose a claim against the estate).

The Court concludes Woods Fuller does not hold or represent an interest adverse to Debtor or the estate. Yes, the firm holds an interest of its own as a pre-petition creditor, and yes, it previously represented Debtor. Those interests, however, despite Tri-State Financial's allegations to the contrary, are not competing interests. The bankruptcy estate (Trustee Lovald),

Debtor, and Woods Fuller are all best served if the bankruptcy estate is maximized. Tri-State Financial may disagree with Trustee Lovald's various decisions, as aided by Woods Fuller's legal counsel, regarding the resolution of the construction-related claims, especially North Central's. Those disagreements alone do not metamorphize into an adverse interest held or represented by Woods Fuller contrary to the employment standards for special counsel dictated by § 327(e).

The same is true regarding Tri-State Financial's recurring argument in its objection to Woods Fuller's proofs of claim, its objection to Woods Fuller's second fee application, and its new motion to disqualify the firm as counsel for Trustee Lovald that because Woods Fuller advised a different legal strategy regarding resolution of North Central's claim after the case converted to Chapter 7, the firm is no longer qualified to serve as counsel for the estate under § 327(e) and the firm has breached its obligations to Debtor and the equity security holders.⁴ In its recent motion to have Woods Fuller disqualified, Tri-State Financial argued:⁵

⁴ As noted above, Tri-State Financial also made this argument as one of its objections to Trustee Lovald's proposed settlement of the North Central claim. The propriety of the proposed settlement is currently under advisement.

⁵ In its recent motion to disqualify Woods Fuller, Tri-State Financial also argued Woods Fuller is retaliating against Tri-State

[Woods Fuller] has failed to explain how the same information obtained from the Debtor can be the basis of the positions against [North Central] and Gaylor that [Woods Fuller] formerly advocated to the Debtor and also be the basis of the opposite positions against [North Central] and Gaylor that [Woods Fuller] now advocates in representing the Trustee.

The Court is hard-pressed to follow this argument. First, whether to propose a settlement of North Central's claim was Trustee Lovald's decision, not Woods Fuller's. What information Trustee Lovald received and used in making that decision was adequately put on the record during the hearing on Trustee Lovald's proposed settlement with North Central. Second, settlements of pending litigation are common in the practice of law, including Chapter 7 bankruptcy cases. Parties often consider and prepare for litigation only to later reach a compromise. Tri-State Financial's transmutation of Trustee Lovald's proposed settlement with North Central into evidence Woods Fuller has given Trustee Lovald legal advice that inherently or intentionally harms Debtor or into evidence Woods Fuller has violated any continuing professional duty owed Debtor is untenable. Third, Tri-State Financial has not cited any case law under §§ 327(e), 328, or 330(a) to support its position that Woods Fuller should be neither employed nor paid by

Financial by asking the District Court to revoke Tri-State Financial's out of state attorney's *pro hac vice* status. That argument is best left to the District Court to hear, if necessary, as part of the matters pending before it.

the bankruptcy estate because Trustee Lovald decided to settle with North Central rather than litigate the construction issues, which upon Woods Fuller's legal advice, Debtor once planned to do. If such case law exists, it would have to discuss and support Tri-State Financial's apparent legal conclusion that a debtor's former attorney may be employed as special counsel by a case trustee under § 327(e) but only as long as the trustee makes the same decisions the debtor would have made if it were still in control of the subject litigation. If that standard were true, § 327(e) would offer no value for a bankruptcy estate in being able to hire a debtor's attorney as special counsel, and special counsel would be unable to fulfill their duties to the estate. Moreover, that standard would ignore a basic bankruptcy principle that a Chapter 7 trustee and the debtor are uni-bound in the trustee's effort to expeditiously maximize the estate. 11 U.S.C. § 521(a)(3)(debtor has duty to cooperate with trustee "as necessary to enable the trustee to perform the trustee's duties"); 11 U.S.C. § 521(a)(4)(debtor must surrender property of the estate and recorded information); and 11 U.S.C. 704(a)(1)(trustee shall "collect and reduce to money the property of the estate...and close such estate as expeditiously as is compatible with the best interests of parties in interest"). See *Lewis v. Cowan (In re Cowan)*, 235 B.R. 922, 924-25 (Bankr. W.D. Mo. 1999)(trustee has the duty to maximize the estate, and his

actions must be compatible with the best interest of all parties in interest, which includes the debtor, creditors, and others with a pecuniary interest)(cites therein).

Finally, Woods Fuller's employment under § 327(e) is not derailed by the standards set forth in *Pierce*, 809 F.2d at 1363.⁶

⁶ In holding that a pre-petition mortgage on a debtor's real estate could constitute an adverse interest under 11 U.S.C. § 327(a), the Court cited *In re Martin*, 59 B.R. 140, 143 (Bankr. D. Maine 1986), and added *Roberts*, 46 B.R. at 849, as a "see also" citation. One court has subsequently discussed this provision in *Pierce*.

[A]ny *per se* rule [the *Pierce* decision] it might have suggested was dicta offered with only minimal justification. The debtors in *Pierce* owed the attorney a prepetition debt for services in connection with a state court lawsuit and gave him a mortgage that secured that debt as well as payment of his postpetition fees for bankruptcy services. The bankruptcy court ruled that the attorney was not disinterested because he was a "creditor" and held the mortgage to secure payment of prepetition and postpetition fees. [*In re Pierce*, 53 B.R. 825, 828 (Bankr. D. Minn. 1985).] The Eighth Circuit affirmed this ruling. Then, the circuit went on to suggest that the bankruptcy court could also have denied the attorney's fees because the mortgage gave him an interest adverse to the estate, citing a decision by a bankruptcy court in the First Circuit, *In re Martin*, [59 B.R. 140, 143 (Bankr. D. Maine 1986)] for the rule that a mortgage securing postpetition legal fees creates an adverse interest, but otherwise offering no explanation why there should be a *per se* disqualification rule. [*Pierce*, 809 F.2d at 1362.]^f Whether the circuit viewed this as a mandatory rule is unclear because it said the bankruptcy court "could ... have denied" the fees based on the mortgage, not that it was required to deny the fees for this reason. In any event, the *Martin* bankruptcy court decision was reversed by the First Circuit a couple of months after the Eighth Circuit decided *Pierce*, [see *In re Martin*, 817 F.2d 175 (1st Cir.1987)] so the Eighth Circuit's dicta possibly suggesting a *per se* rule that having a mortgage to secure payment of fees always disqualifies an attorney from representing the debtor in a bankruptcy case was seriously undermined shortly after its opinion was issued.

The firm does not hold a mortgage on estate property, and its representation of Debtor pre-petition and during the Chapter 11 were all disclosed prior to the firm's employment by Trustee Lovald under § 327(e).

To the extent Tri-State Financial's pending objection to Woods Fuller's proof of claim 261⁷ or its objection to Woods Fuller's second fee application rely on arguments that Woods Fuller is not eligible for employment under § 327(e) or may not be paid under §§ 328 or 330 because the firm is not disinterested, because the

^f The Eighth Circuit also cited *In re Roberts*, 46 B.R. 815, 849 (Bankr. D. Utah 1985) for the proposition that a debt owed to an attorney for fees for prepetition, nonbankruptcy work would create an adverse interest. *Roberts* is not relevant here because the Debtors do not owe Stumbo, Hanson any debt for prepetition legal services not related to the bankruptcy filing.

In re Mall, Bankr. No. 04-40381-11, 2004 WL 2187166, slip op. at 2 (Bankr. D. Kan. 2004 July 28, 2004)[citations that were in footnotes have been inserted into the text]. Other courts have accepted the *per se* rule in *Pierce* without discussion. See, e.g., *In re Brick Hearth Pizza, Inc.*, 302 B.R. 877, 884 n.10 (Bankr. D. Minn. 2003). This Court is inclined to conclude the Court of Appeals would not now impose a *per se* disqualification rule in a § 327(e) context, especially in light of *In re Martin*, 817 F.2d 175 (1st Cir. 1987), and other subsequent case law.

⁷ In its response to Tri-State Financial's December 14, 2006 objection to Woods Fuller's proofs of claim 261 and 395, Woods Fuller stated the fee order entered May 5, 2005 satisfied proof of claim 395 in full. No appeal from that order was taken. Accordingly, claim 395 is no longer at issue and Tri-State Financial's December 14, 2006 objection to that claim is moot.

firm holds an interest adverse to the estate or Debtor, or because the firm counseled Trustee Lovald to settle North Central's claim, those objections are overruled. The same is true for Tri-State Financial's recent motion to disqualify Woods Fuller. To the extent Tri-State Financial relies on these same legal theories for the relief sought in that motion, it also is denied.

As to Tri-State Financial's objection to Woods Fuller's proof of claim no. 261, the following bases for the objection are unresolved: (1) whether Woods Fuller's pre-petition services, as set forth in its proof of claim no. 261, had to be approved by Debtor's board of managers pre-petition before the claim now may be paid by the bankruptcy estate, and if so, whether these pre-petition services were so approved; (2) whether Woods Fuller had to submit to Debtor pre-petition detailed invoices regarding the sums sought under its proof of claim no. 261 before the claim may now be paid by the bankruptcy estate; and (3) whether any "law of the case" established by the District Court during an appeal regarding the claim filed by James Jandrain requires the disallowance of Woods Fuller's proof of claim no. 261. An evidentiary hearing may be needed to resolve the first two remaining bases for the objection. The Court is unsure to what "law of the case" Tri-State Financial is referring in the third remaining basis. Accordingly, it will be discussed with counsel during a pre-hearing conference.

The pre-hearing conference will be set after the Court rules on Trustee Lovald's proposed settlement with North Central.

As to Tri-State Financial's objection to Woods Fuller's second fee application, the following bases for the objection remain unresolved: (1) whether some post-conversion services failed to benefit the estate; and (2) whether some fees were unreasonable, excessive, or duplicative. An evidentiary hearing will be set on these, also after resolution of Trustee Lovald's proposed settlement with North Central. In the interim, it would be useful if Tri-State Financial would, using Woods Fuller's fee itemization attached to the second fee application, file a supplement to its objection that better identifies each entry to which it objects and that sets forth the specific reason for the objection to each entry. The reasons set forth, of course, must be something other than Woods Fuller counseled Trustee Lovald to settle North Central's claim.

As to Tri-State Financial's motion to disqualify Woods Fuller as Trustee Lovald's attorney, most of the bases for it have been resolved in the Court's discussion above regarding the firms' employment under § 327(e). Further, as noted above on page 18, n.5, Tri-State Financial's argument in paragraph 22 of the motion will be left for the District Court to consider. Tri-State Financial's argument in paragraph 21 will be adequately addressed

when Trustee Lovald's proposed settlement with North Central is ruled upon. What is left is Tri-State Financial's argument that Woods Fuller has violated some continuing fiduciary or professional duty to Debtor. An order will be entered setting a deadline for Tri-State Financial to provide case law support for this argument in a brief. The case law must be relevant to the present circumstances, *i.e.*, a corporate Chapter 11 debtor converted to Chapter 7. In its brief, Tri-State Financial cannot ignore the fact that the Chapter 7 case renders Debtor defunct, *Braden v. Tri-R Builders, Inc. (In re Tri-R Builders, Inc.)*, 86 B.R. 138, 141 (Bankr. N.D. Ind. 1986), and that Trustee Lovald is now in control since Debtor's board of managers has been "completely ousted." *Commodity Futures Trading Commission v. Weintraub*, 471 U.S. 343, 352-53 (1985). Tri-State Financial also cannot ignore the fact that Trustee Lovald controls any attorney-client privilege held by Debtor. *Weintraub*, 471 U.S. at 352-56. Finally, Tri-State Financial cannot ignore the fact that while Trustee Lovald holds a fiduciary duty to Debtor's equity holders as well as to the other creditors,

[o]ne of the painful facts of bankruptcy is that the interests of shareholders become subordinated to the interests of creditors. In cases in which it is clear that the estate is not large enough to cover any shareholder claims, the trustee's exercise of the corporation's attorney-client privilege will benefit only creditors, but there is nothing anomalous in this result;

rather, it is in keeping with the hierarchy of interests

created by the bankruptcy laws. See generally 11 U.S.C. § 726(a).

Id. at 355. Once Tri-State Financial has filed its supporting brief, Woods Fuller will be given an opportunity to file a responsive brief, and an evidentiary hearing will be set by separate order, if needed.

III.

PENDING MATTERS REGARDING DISCOVERY.

Woods Fuller and Tri-State Financial both have a discovery-related motion pending that are essentially attempts to resolve the same dispute. Woods Fuller has also filed a motion seeking access to a transcript from the early hearing on asserted privileges. These three motions will all be denied without prejudice. Because some bases for Tri-State Financial's objection to Woods Fuller's proof of claim 261 and its objection to Woods Fuller's second fee application have been resolved on legal grounds as set forth above, the potential discovery disputes have also been narrowed. Accordingly, the parties should confer and attempt to resolve any discovery issues related to Tri-State Financial's remaining objections to Woods Fuller's proof of claim no. 261 and its remaining objections to Woods Fuller's second fee application. Those that cannot be resolved by the parties may be brought before

the Court by an appropriate new motion under Fed.R.Bankr.P. 7026 and Fed.R.Civ.P. 26. The Court advises all parties, however, that the attorney-client and work product privileges resolved on December 20, 2006, will not be revisited. The rulings on December 20, 2006, are relevant and controlling in the context of Woods Fuller's fee claim and fee application.

The transcript request made by Woods Fuller for the privileged exhibit hearing on December 20, 2006, is more problematic. The transcript is very poor and incomplete due to a very poor electronic sound recording. While the Court has a record of the disposition of each document on which Trustee Lovald claimed a privilege, each party's argument and the Court's discussion regarding each ruling are incomplete. If and when privilege issues arise anew, the Court will have the disposition notes to refer to, but the transcript itself will have limited value. For that reason alone, Woods Fuller's motion for release of the sealed transcript will be denied.

As to Tri-State Financial's related motion seeking a hearing on the discovery issues and a continuance of the evidentiary hearing set on Woods Fuller's proof of claim and second fee application, it will be granted in part and denied in part. A hearing on the discovery motions will not be held because those motions are being denied without prejudice. The evidentiary

hearing on Tri-State Financial's objection to Woods Fuller's proof of claim no. 261 and Woods Fuller's second fee application will be reset during the pre-hearing conference on Tri-State Financial's objection to Woods Fuller's proof of claim no. 261.

IV.

SUBSTITUTION OF TRI-STATE FINANCIAL'S LOCAL COUNSEL.

Trustee Lovald's March 16, 2007, *Motion for Reconsideration of Order Granting Tri-State Financial, LLC's Motion to Substitute Counsel, and Objection to Tri-State Financial, LLC's Motion to Substitute Counsel* will be denied without prejudice. If the role of local counsel is integral to a resolution of the *pro hac vice* matters pending before the District Court, then it is more appropriate for District Court to consider them. If any of the issues first raised in the *Motion for Reconsideration of Order Granting Tri-State Financial, LLC's Motion to Substitute Counsel, and Objection to Tri-State Financial, LLC's Motion to Substitute Counsel* still need to be addressed by this Court after the District Court rules, Trustee Lovald may file a new motion.

Appropriate orders have been or will be entered.⁸

Dated this 2nd day of May, 2007.

⁸ The original Memorandum of Decision and attendant orders were entered April 18, 2007. Only one of the previously-entered orders needed to be amended to reflect the changes in this Amended Memorandum of Decision.

UNITED STATES BANKRUPTCY COURT
DISTRICT OF SOUTH DAKOTA

In re:) Bankr. No. 03-10194
) Chapter 7
TRI-STATE ETHANOL COMPANY LLC)
)
Debtor.) AMENDED ORDER DENYING WITHOUT
) PREJUDICE TRUSTEE JOHN S.
) LOVALD'S MOTION TO RECONSIDER
) SUBSTITUTION OF COUNSEL ORDER

In recognition of and compliance with the *Memorandum re: Several Pending Matters* entered this day and for cause shown,

IT IS HEREBY ORDERED Trustee John S. Lovald's March 16, 2007, *Motion for Reconsideration of Order Granting Tri-State Financial, LLC's Motion to Substitute Counsel, and Objection to Tri-State Financial, LLC's Motion to Substitute Counsel* is DENIED without prejudice.

So ordered: May 2, 2007.