UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF OHIO
WESTERN DIVISION

In Re:	)	Case No. 02-30182
	)	
Juan M. Espinoza,	)	Chapter 7
	)	
Debtor.	)	
	)	JUDGE MARY ANN WHIPPLE

MEMORANDUM OF DECISION RE MOTION TO COMPROMISE CLAIMS OF ESTATE AND MOTION TO CONVERT CHAPTER 7 CASE TO CHAPTER 13

This case came before the court for hearing on September 14, 2004, upon both the Trustee's Motion for Authority and Notice of Intent to Compromise Claim [Doc. #25], to which Debtor objected [Doc. # 26], and Debtor's Motion to Convert Chapter 7 Case to Chapter 13 [Doc. #38]. Debtor and the Chapter 7 Trustee each appeared in person. At a prior hearing on July 13, 2004, on the motion to compromise, the Trustee was directed to follow up to determine if there would be a return to creditors by the proposed settlement of the Estate's employment discrimination claim against Debtor's employer, and Mr. Espinoza was directed to consider requesting other relief. Thereafter, pursuant to the court's directives, the Chapter 7 Trustee filed a motion for apportionment of the proposed settlement and Mr. Espinoza filed a motion to convert this case to Chapter 13.

After hearing on the motion for apportionment of the proposed settlement, the court granted the motion in an order dated August 30, 2004, conditioned upon a decision that the proposed compromise is in the best interest of the estate and that the motion for approval should be granted. The court found that the Trustee's proposed methodology of dividing the proposed settlement amount between the estate and Mr. Espinoza is reasonable and provides a dividend to unsecured creditors, which the Trustee indicated would be approximately 54.9%. The Trustee represented that, under the proposed apportionment, after counsel's fees and expenses are paid, the bankruptcy estate would receive $7,044 and Debtor would receive $6,146. At the August 30 hearing, the motion to compromise was set for further hearing on September 14, 2004, the date also set for hearing on Debtor's motion to convert the case to one under Chapter 13.

At the September 14 hearing, the court issued an oral ruling denying Debtor's motion to convert to a Chapter 13 case and conditionally granting the Trustee's motion to approve settlement. At this point in the proceedings, however, the precise terms of the compromise were still not known

to the court because the agreement had not been finally reduced to writing. The court therefore directed the Trustee to submit a final draft of the settlement agreement to be attached to an order memorializing the court's oral ruling.

On October 19, 2004, the Trustee submitted a final draft of the settlement agreement. At that time, he also provided notice that there would likely be a variance in the amount to be received by the estate as a result of the settlement as compared to representations made to the court at the time of the court's oral ruling. [Doc. # 49]. Of particular concern to the court was whether income tax will be withheld from the proposed settlement amount and the rate of income tax to be withheld. Based upon these additional factors, the court was concerned that the premise upon which it relied in its oral rulings may no longer be valid, i.e. that the proposed settlement would permit a significant dividend to be paid to unsecured creditors over and above that which would be available under a Chapter 13 plan as proposed by Debtor. Thus, a further hearing was held on November 1, 2004, after which the Trustee was directed to file a status report addressing the court's new concerns and the tax issues in particular.

The Trustee's status report was filed on January 21, 2005, setting forth the anticipated tax consequences of the settlement.[1] [Doc. # 69]. The net amount that will be due the bankruptcy estate, after the fees and expenses of Special Counsel and taxes and after the apportionment approved by the court, is approximately $3,943. In addition, the Trustee reports that the estate has an additional $1,716 on hand. This amount, together with the settlement monies to which the estate would be entitled, totals approximately $5,659.

The court first addresses Debtor's motion to convert to a Chapter 13 case. In seeking to convert the case to one under Chapter 13, Debtor seeks an avenue to retain the right to pursue and control resolution of the claims against his employer through a jury trial. In connection with this motion, the court directed Debtor to file amended schedules I and J. The amended schedules indicate

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[1] Debtor filed an objection to the Trustee's status report. [Doc. # 70]. He objects to the manner in which the income tax burden is set forth in the status report and argues that Special Counsel, the Trustee, and Debtor should share equally the income tax burden. While the status report states the net settlement amount, after deduction of taxes, that the estate and Debtor will be jointly paid, it is unclear from the report the amount on which that calculation was made (i.e. on the entire settlement amount of $20,000 or on $20,000 less attorney fees and expenses paid to Special Counsel). The court notes, however, that Congress amended the Internal Revenue Code when it enacted the American Jobs Creation Act of 2004, 118 Stat. 1418, which allows a taxpayer, in computing adjusted gross income, to deduct "attorney fees and court costs paid by, or on behalf of, the taxpayer in connection with any action involving a claim of unlawful discrimination." 26 U.S.C. § 62(a)(19). Nevertheless, this issue does not affect the court's decision regarding the motions before it. To the extent that the projected tax liability of the estate and Debtor was calculated incorrectly on the entire $20,000 settlement proceeds without accounting for the available deduction, the error may be corrected and will leave additional funds for distribution to creditors that the court has not even considered.

that Debtor's net monthly income is $1,688 and monthly expenses are $1,592 and that $50 per month would be paid into his Chapter 13 plan. Even assuming that the plan would also include an additional payment to creditors in the event he prevails in his discrimination claim, given the speculative nature of and necessary additional delay attendant to any recovery actually being obtained, the court finds that Debtor is not able to fund a confirmable Chapter 13 plan.

Under 11 U.S.C. § 1325(a)(4), which is often called the "best interests test," creditors must receive under a Chapter 13 plan at least as much as they would receive under a Chapter 7 liquidation. For purposes of the best interests test, the court will value the claim against Mr. Espinoza's employer at the proposed settlement amount. Based on Mr. Espinoza's ability to fund a plan, and assuming the maximum plan payment period of five years, unsecured creditors would be certain to receive only $2,700 after deducting the Chapter 13 Trustee's 10% maximum fee, *see* 28 U.S.C. § 586(e). This contrasts with the approximately $4,000, after deduction of the Chapter 7 Trustee's statutory fees under 11 U.S.C. § 326(a), that creditors could be certain to receive in a Chapter 7 liquidation in which Debtor's discrimination claim is settled as proposed. And this calculation is being made without including any administrative expense claim for the superceded Chapter 7 Trustee, which this court routinely permits upon conversions from Chapter7 to Chapter 13 occurring after the discovery and administration of estate assets. *See In re Wells*, 87 B.R. 732, 736, n.3 (Bankr. N.D. Ga. 1988). For these reasons, and those otherwise stated on the record at the September 14, 2004, hearing, Debtor's motion to convert to a Chapter 13 case will be denied. The best interest of creditors test cannot be satisfied in the prospective Chapter 13 case.

The court next addresses the Chapter 7 Trustee's motion to compromise Debtor's claim against his employer. In deciding whether to approve a proposed settlement, the bankruptcy court must determine whether the settlement is in the best interests of the estate. *McGraw v. Yelverton (In re Bell & Beckwith)*, 87 B.R. 476, 478 (N.D. Ohio 1988). In making this determination, the court considers the following factors:

> (1) the probability of success in litigation;
> (2) the difficulties, if any, to be encountered in collecting any judgments that might be rendered;
> (3) the complexity of the litigation involved, as well as the expense, inconvenience and delay necessarily attendant to the litigation; and
> (4) the paramount interests of creditors with proper deference to their reasonable views.

Id. (citing *In re A & C Properties,* 784 F.2d 1377, 1381 (9th Cir. 1986)). In considering these factors, the court does not resolve disputed factual and legal issues, nor should it substitute its judgment for that of the trustee. *Id.* It should, however, canvass and inform itself of the issues and determine whether the proposed settlement "'falls below the lowest point in the range of reasonableness.'" *Id.* at 479 (citation omitted). The Trustee, as the proponent of the compromise, has the burden of persuasion that the settlement is in the best interest of the estate. *Id.* at 478.

The Chapter 7 Trustee has negotiated a proposed monetary settlement of $20,000. As to the first factor of probability of success in the litigation, the Chapter 7 Trustee indicates that Debtor's discrimination claims are hotly contested by the employer, as most are, and present many potential pitfalls. Mr. Espinoza does not contest that the claims are being aggressively defended. This is in accord with the assessment of counsel appointed to represent the estate in this matter in August 2003 that there is "a substantial risk of losing at trial." [Doc. #45, unnumbered p. 10]. While Mr. Espinoza's damages would appear to be readily calculable, the crux of the case is in the bitter dispute over liability. Analysis of the first factor supports approval of the Trustee's proposed settlement.

As to the second factor of the collectibility of any judgment, Debtor's employer is a large corporation, Kelsey-Hayes Company. There has been no suggestion that it would be difficult to collect any judgment rendered after trial from the employer. The second factor does not mitigate in favor of approval of the settlement.

As to the third factor of complexity, expense, inconvenience and delay, there is no indication of any unusual complexity of the law or facts underpinning the claims. Expense, inconvenience and delay are, however, significant factors in the analysis. Given the contested nature and the type of the claims at issue, it is not unlikely that Debtor's employer would pursue an appeal in the event the estate did prevail at trial. The estate, and thus, creditors would not realize any recovery until after any appeal was decided. Mr. Espinoza's Chapter 7 case has already been pending for three years due to the fiduciary necessity of administration of the underlying litigation, which is pending before Judge David A. Katz in the United States District Court for the Northern District of Ohio, Western Division. While trial dates are set expeditiously in that court, trial would still be months away if the settlement is not approved. The appeal process would entail many more months, if not a year or more. The proposed settlement, on the other hand, will allow a more timely and certain payment to creditors. The factor of additional delay mitigates strongly in favor of approving the settlement.

Given the nature of the case and the fact that Debtor's claims are hotly contested, the expense of further litigation is also a factor the court must consider, especially in light of the fact that the other

estate assets with which to fund the litigation total only $1,716. Costs of $1,497.50 have already been incurred. Trial expenses would likely exceed the cash on hand in the estate. The factor of additional litigation costs that the estate has a limited ability to fund also mitigate strongly in favor of approving the settlement.

As to the fourth factor of the paramount interests of creditors, with deference to their reasonable views, no creditors have expressed any specific view as to whether the settlement is in the best interest of the estate. One of the primary reasons Mr. Espinoza objects to the settlement is that he believes that there are larger and more important principles involved than just money. Specifically, he is concerned that to the extent Kelsey-Hayes has discriminated against him, it will be free to do so as to himself and other employees after this settlement. Nothing will change or improve in this workplace based on this settlement.

As the court has previously expressed at hearings, the court agrees that bigger principles than just money are always at stake under the civil rights laws of this country. To be frank, however, that is simply not an issue in which Debtor's creditors have any stake. To the contrary, all the creditors want is money. They are entitled to expect that the Trustee will liquidate the claims to that end, and not use estate assets to litigate larger policy issues that will not benefit the estate. Mr. Espinoza's understandable frustration is born of the very fact of bankruptcy. Pre-petition claims become property of the bankruptcy estate under 11 U.S.C. § 541(a) upon commencement of the case, necessarily resulting in a loss of control over such claims in favor of a Chapter 7 trustee. A bankruptcy estate's interests are not necessarily the same as and aligned with a debtor's interests in the outcome of litigation. The loss of control over the outcome of pre-petition claims, which is the source of Mr. Espinoza' frustration and objections, is one of the unavoidable costs built into the bankruptcy process of obtaining a fresh start through discharge.[2]

Moreover, based on the Trustee's proposed apportionment of the settlement recovery as between the estate and Mr. Espinoza, which the court has found to be fair and reasonable, the estate's monetary upside is limited, to underpaid wages accruing up until the commencement of the bankruptcy case. The estate will occur substantial risk and expense for a relatively small upside. Thus, taking the jury trial risk is not in the best interest of creditors in this case.

Mr. Espinoza's other objections are directed at the contingency fee proposed to be paid to

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[2]Mr. Espinoza has discharged nearly $30,000 in scheduled unsecured debt and avoided two judgment liens on his home.

special counsel out of the settlement proceeds and to special counsel's disinterestedness. These arguments do not specifically fit into any of the factors for analysis established by the case law, but will be considered by the court as part of the totality of the circumstances relevant to the motions before the court for decision.

Debtor argues that the fee should be calculated on the net *after* litigation expenses are deducted from the $20,000 total. In the Chapter 7 Trustee's notice of submission of the settlement agreement [Doc. #49] filed on October 19, 2004, he seems to agree with Mr. Espinoza on this point. The order approving the employment application [Doc. #13] specifies that the contingency fee is to be calculated based on "any net recovery, less expenses."[3] The court acknowledges that this language is less than crystal clear. The use of the terms "net" and "less expenses" seems redundant. However, the court interprets this language to mean that the litigation costs should be deducted first, and then the contingency fee percentage applied. That is the routine basis upon which contingency fee employment applications are approved in this court, and which the Office of the United States Trustee supports; it did not assert any objection to employment in this case. Therefore, the total fee payment for purposes of evaluating the settlement, its reasonableness and the generation of a meaningful dividend to unsecured creditors therefrom will be presumed as $6,167.65 ($20,000 less costs of $1,497.05 = $18,502.95 divided by 3 = $6,167.65). As that is approximately $500.00 less than the $6,660.00 upon which the Trustee's calculations have been based, the estate's share and the apportionment to Mr. Espinoza will each increase slightly in administration of the settlement. That increase speaks in further favor of granting the motion to approve the compromise.

The court disagrees with Mr. Espinoza, however, to the extent he is arguing that counsel's contingency fee should be calculated only after taxes are deducted from the $20,000. *See* Doc. #70. Income taxes are simply not a cost and expense of litigation.

Lastly, Mr Espinoza argues that the settlement is the product of nothing so much as special counsel's failure of will to try the case, with the bankruptcy filing being an easy out to recover a quick

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[3]The court notes that there is a divergence between the order approving employment of special counsel [Doc. #13], the application [Doc. #12] and the underlying contract [Doc. #12]. The order specifies a 40% contingency percentage. But the application specifies only 33 1/3%, as does counsel's original fee agreement with counsel. All of the written and oral presentations on this matter have focused on a 33 1/3% contingency percentage. Special counsel has not appeared and argued otherwise. *See also* Doc. #45, unnumbered page 9 (letter from Attorney Rice to Debtor acknowledging that fee percentage is 33/3 %). Therefore, the court finds that the order approving employment contains a clerical mistake, and that the correct percentage is 33 1/3 %, not 40%. That still does not resolve the issue of what the percentage is to be calculated on.

fee and run. Further, Mr. Espinoza points out the undeniable fact that that the person recovering the most from the settlement is special counsel -- more than Mr. Espinoza and substantially more than the estate will retain for distribution to creditors. As to the former point, the bankruptcy filing likely did negatively impact the settlement value of the claim. But again, that's a byproduct of bankruptcy. There is extensive correspondence from special counsel in the record, and it shows the court that counsel is appropriately evaluating the claims, prosecuting them and representing the interests of both the estate and Mr. Espinoza (such as through a settlement agreement that does not result in his resignation from employment). The latter point as to the special counsel's fee is more a function of the contingency fee basis upon which special counsel's employment was approved, which is routine, than a factor that negatively impacts the reasonableness of the settlement. Trustees would find themselves unable to employ counsel to litigate most employment and tort claims that become property of the estate absent contingency fees, which are expressly authorized by the Bankruptcy Code. 11 U.S.C. § 328(a).

In summary, the court finds that the weight of the traditional four factors, and the other circumstances explained above, show that the Trustee's proposed settlement does not fall below the lowest point of reasonableness, and that it is in the best interests of the estate.

The court will enter a separate order in accordance with this memorandum of decision.

Mary Ann Whipple
United States Bankruptcy Judge