

SUPREME COURT OF THE STATE OF NEW YORK – NEW YORK COUNTY

PRESENT: IRA GAMMERMAN
Justice

PART _____

Source Enterprises, Inc.

INDEX NO. 110684/09

MOTION DATE _____

MOTION SEQ. NO. 001

Windels Marx Lane & Mittenboff

MOTION CAL. NO. _____

The following papers, numbered 1 to _____ were read on this motion to/for _____

Notice of Motion/ Order to Show Cause – Affidavits – Exhibits ...

Answering Affidavits – Exhibits _____

Replying Affidavits _____

PAPERS NUMBERED

Cross-Motion: Yes No

Upon the foregoing papers, it is ordered that this motion

*is decided in accordance with
the accompanying memo decision.*

It is so ordered.

Enter:

MOTION SUPPORT OFFICE
NYS SUPREME COURT - CIVIL
JUL 14 2010
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Dated: 7-8-2010

IRA GAMMERMAN

JSG JHO

Check one: FINAL DISPOSITION NON-FINAL DISPOSITION

Check if appropriate: DO NOT POST

THIS DOCUMENT IS RESPECTFULLY REFERRED TO JUSTICE FOR THE FOLLOWING REASON(S):

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SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK

----- x
SOURCE ENTERPRISES, INC., SOURCE
ENTERTAINMENT, INC., SOURCE MAGAZINE,
LLC and BLACK ENTERPRISE/GREENWICH
STREET CORPORATE GROWTH PARTNERS, L.P.,

Plaintiffs,

-against-

Index No. 110684/09
PC No. 23174

WINDELS MARX LANE & MITTENDORF, LLP,

Defendant.

----- x
IRA GAMMERMAN, J.H.O.:

Plaintiffs bring this action against their former bankruptcy attorneys for alleged breaches related to that representation. Defendant, the former bankruptcy law firm, moves to dismiss the complaint based on the res judicata effect of proceedings held in the bankruptcy court, *In re Source Enterprises, Inc.*, 2008 WL 850229 (Bankr, SD NY 2008).

In the present action, plaintiffs, consisting of Source Enterprises, Inc., Source Entertainment, Inc. and Source Magazine, LLC, (collectively, "Source") and Black Enterprise/Greenwich Street Corporate Growth Partners, L.P. ("BE/GS") allege that defendant Windels Marx Lane & Mittendorf, LLP ("Windels"), violated sections of the New York State Judiciary Law, breached fiduciary duties owed to plaintiffs, and

committed malpractice in connection with misrepresentations allegedly made to plaintiffs and the bankruptcy court.

In 2007, Windels applied to the bankruptcy court for payment of its fees and reimbursement of its expenses in connection with its representation of Source. Source filed written objections to Windels's application in those proceedings, based on Windels's status as a pre-petition creditor of Source and its alleged lack of disinterestedness. Disinterestedness is required by Bankruptcy Code § 327 (a) before counsel can qualify to represent a debtor in bankruptcy court. Source also objected to Windels's fee application based on Windels's alleged failure to disclose promises that it would be paid its fees at the conclusion of the bankruptcy proceedings. Finally, Source objected to Windels's precipitous withdrawal from the representation, after receiving a partial payment from Source, without disclosing that payment to the court.

Source now seeks to prosecute claims of statutory breaches, as well as claims of malpractice and breach of fiduciary duty, all of which arise from the same set of operative facts that were before the bankruptcy court when it considered Windels's fee application.

Res judicata is a "fundamental precept of common law adjudication," *Penthouse Media Group, Inc. v Pachulski Stang Ziehl & Jones LLP*, 406 BR 453, 458 (SD NY 2009) (internal citations omitted). This principle states that "a right, question or fact distinctly put in issue and directly determined by a court of competent jurisdiction . . . cannot be disputed in a subsequent suit between the same parties or their privies. . . ." *id.*

(internal quotation marks and citation omitted). The public policy behind res judicata is avoiding multiple lawsuits by parties who have had a “full and fair opportunity to litigate” their disputes, in order to “conserv[e] judicial resources, and foste[r] reliance on judicial action by minimizing the possibility of inconsistent decisions,” *id.* (internal quotation marks and citation omitted).

Source contends that its claims are not barred by res judicata since it could not have interjected counterclaims into the Bankruptcy proceedings. Source claims that those proceedings were merely “contested,” rather than “adversarial,” a distinction which turns on the alleged expedited character of the fee hearing. Disputed professional fee applications are contested matters, Source claims, since they are not included in the list of “adversary proceedings” contained in the Federal Rules of Bankruptcy Procedure, Rule 7001, and have been described as contested matters in the Federal Rules of Bankruptcy Procedure, Rule 9014, Advisory Committee Notes. Since this was not an adversarial proceeding, Source’s claims were not “compulsory counterclaims,” and are, thus, not barred by res judicata.

Despite Source’s claim that this was an expeditious, contested proceeding, rather than a full-blown adversarial proceeding, it is worth noting that at the conclusion of Source’s written objections to Windels’s fee application in bankruptcy court, Source expressly reserved the right “to raise any and all substantive arguments with regard to the Windels Marx Fee Application at the hearing on the Windels Marx Fee Application,

whether or not such arguments [were] raised [in the written objections], Aff. of Frederick B. Warder III, dated September 16, 2009, Ex. C., at 8.

Furthermore, although New York does not have a compulsory counterclaim rule, Source cannot remain silent with respect to its malpractice claims during the fee proceedings in bankruptcy court, and “then bring a second action seeking relief inconsistent with the judgment in the first action by asserting what is simply a new legal theory,” *Image Innovations Holdings*, 391 BR 255, 261 (Bankr, SD NY 2008) (internal citations omitted). The bankruptcy court passed judgment and afforded relief in connection with Windels’s conduct, and it is not within this court’s power to reopen issues of liability or damages in these proceedings merely because Source chose to remain silent when the issues were being considered by the bankruptcy court judge.

After three days of hearings, conducted on November 28 and 29 and December 10, 2007, the bankruptcy court made findings of fact and conclusions of law on the issue of Windels’s self-interest in Source’s assets, its failure to disclose its status as a creditor of Source, and its breach of ethical standards as grounds for denying fees to Windels. In its decision following the hearings, the bankruptcy court concluded as follows:

the Court finds that Windels was a creditor of Enterprises when it sought to be retained and, as a result, was not “disinterested” and therefore not qualified to serve as bankruptcy counsel. Further, Windels failed to disclose its creditor status and other important connections relevant to the determination of its suitability to be retained. Finally, Windels breached its ethical,

professional obligations by failing to adequately represent the Debtor and these failures harmed the estate.

In re Source Enterprises, Inc., 2008 WL 850229 (Bankr, SD NY 2008). The bankruptcy court ordered Windels to disgorge \$50,000 it had collected in fees from Source, post-petition. The court also permitted Windels approximately one month to request reimbursement of expenses it incurred in its capacity as counsel to Source, not to exceed \$31,175.09, and additional time to file a Supplemental Expense Application. According to the record before me, such requests were never submitted to the bankruptcy court.

The bankruptcy court also expressly retained jurisdiction over the proceedings to interpret and enforce the terms of its order, dated April 4, 2008, *Aff. of Frederick B. Warder III*, dated September 16, 2009, Ex. J, at 3.

The application of res judicata principles to a particular case turns on whether the prior decision, asserted as a bar to the current litigation, was a final judgment on the merits, whether the parties were identical, whether the prior court had competent jurisdiction over the subject matter, and whether the causes of action were the same, *Corbett v MacDonald Moving Servs.*, 124 F3d 82 (2d Cir 1997). A critical question is whether the claim in issue could or should have been asserted in the prior action, *Matter of Howe*, 913 F2d 1138 (5th Cir 1990). “In the bankruptcy context, [courts] ask as well whether an independent judgment in a separate proceeding would impair, destroy, challenge, or invalidate the enforceability or effectiveness’ of the reorganization plan.”

Corbett at 88, citing *Sure-Snap Corp. v State St. Bank and Trust Co.*, 948 F2d 869, 875-76 (2d Cir 1991).

A malpractice claim may remain viable, even after all of these criteria have been met, “unless a party ‘could and should have brought [it] in the former proceeding,’” *Penthouse Media Group* 406 BR at 459, citing *In re Intelogic Trace, Inc.*, 200 F3d 382, 388 (5th Cir 2000). In *Penthouse Media Group*, the parties were permitted to proceed with their independent claim of malpractice because, unlike in the present case, counsel had continued to represent plaintiffs for the duration of the bankruptcy proceedings, plaintiffs had no reason to doubt counsel’s representations that it had properly performed its services, and plaintiffs had no incentive to interpose their claim of malpractice into those proceedings based on their continued reliance on counsel throughout the bankruptcy proceedings.

Here, the bankruptcy court had competent jurisdiction over the fee dispute in issue in the present matter, pursuant to Bankruptcy Code § 330. 11 USC § 330. This type of fee order is immediately appealable and is a final judgment on the merits for purposes of res judicata, *In re Image Innovations Holdings*, 391 BR 244, *supra*. An order on a fee application that completely resolves all of the issues pertaining to the claim, including issues as to appropriate relief, is a final order, *id.* at 260. Such orders are sufficiently final to be appealable where the bankruptcy court disallows fees but allows certain expenses, as in the present case, *see D.A. Elia Constr.* at 318. So long as the bankruptcy court gave

the debtors, the creditors, and the attorney an opportunity to be heard on the “quality and value” of the attorney’s conduct, the order is final and appealable, *id.*

A party who has a pecuniary interest in the distribution of assets in a bankruptcy proceeding is considered to be a party for purposes of res judicata analysis, *Grausz v Englander*, 321 F2d at 473. Where parties to the pending action appeared in the prior fee dispute, such parties are identical for purposes of res judicata, *In re Image Innovation Holdings*, 391 BR at 260.

The parties to the present action are identical to the parties in the fee dispute in bankruptcy court. At the time of the fee dispute, Source was a party-in-interest because it was a debtor in the bankruptcy proceedings, 11 USC § 1109 (b). Section 1109 (b) of the Bankruptcy Code states, “[a] party in interest, including the debtor . . . [and] creditor . . . may raise and may appear and be heard on any issue in a case under this chapter.” Source submitted objections and supplemental objections in the fee dispute, and was represented by counsel, who appeared and participated in the fee hearing, and Source’s Chairman testified on its behalf at the hearing.

Plaintiff BE/GS was also a party in interest. BE/GS filed initial and supplemental objections in the fee dispute, was represented by counsel in the fee dispute proceedings, and presented witnesses on behalf of its interests in the proceedings. BE/GS provided debtor-in-possession financing to Source and had a direct financial interest in the court’s resolution of the fee dispute.

The factual basis for the fee dispute and the causes of action asserted in the present action overlap, and share a common nucleus of operative facts, *see In re Layo*, 460 F3d 289, 292 (2d Cir 2006). Here, both proceedings involve the same operative facts, namely, Windels's conduct during its representation of Source in the bankruptcy proceedings.

In the present complaint, Source claims that Windels erred by failing to disclose to the bankruptcy court that the firm had an agreement with Source to defer certain pre-bankruptcy fees, thus making Windels a creditor of one or more of the actual or potential debtors, or their affiliates, Complaint, ¶¶ 14 -16. Source further alleges that this fee arrangement created a conflict by making Windels an "interested" party, and that Windels deceived its clients and the bankruptcy court by not disclosing its alleged interest in the proceedings, complaint, ¶¶ 16-19. These same issues were raised in Source's objections to the fee application, Aff. of Frederick B. Warder III in Support of Motion to Dismiss, dated September 16, 2009, Exh. E, at 9.

Other claims that mirror the debtor's objections in the bankruptcy proceedings include Windels's delays in filing the reorganization plan and the voluntary bankruptcy petitions for additional Source-related entities, Windels's unauthorized position on the Interim Fee Motion before the bankruptcy court, irregularities in Windels's withdrawal from representation of Source in the bankruptcy court and the unnecessary fees, expenses and delays caused thereby.

Claims are held to be the same if the facts essential to the second case were present

in the first case, *Corbett*, 124 F3d at 89-90. “Sameness” does not require “exact sameness.” Rather substantial sameness is all that is required, *In re Rodriguez v Global Air Parts, LLC*, 327 BR 86, 92 (Bankr, D Conn 2005).

In the present case, the claims asserted in the complaint are substantially identical to the objections raised in the fee dispute, and arise from a common nucleus of operative fact.

A decision which would permit Source to proceed with its malpractice action would impair the finality and effectiveness of the prior rulings in the bankruptcy case, *See Corbett*, 124 F3d at 92. Although the bankruptcy court issued a decision denying fees to Windels, the firm was permitted to submit a request to the court for expenses. The bankruptcy court’s negative findings with respect to Windels’s conduct did not amount to an authorization to bring a suit against Windels which could result in the firm being held responsible for all of the bankruptcy creditors’ losses in the case, *see Image Innovations Holdings*, 391 BR at 261.

Whatever the inference may be from the denial of fees, [the Bankruptcy] Court made a finding on quality and value by awarding expenses, and it left open no room for an independent malpractice action. The fee application and malpractice claim are sufficiently similar that it is appropriate to apply *res judicata*.

Id.

Claims arising out of the same transaction and common nucleus of operative fact

are barred by res judicata even if they are pleaded or pursued under different legal theories in the second action, *Sure-Snap v State St. Bank and Trust Co.*, 948 F2d 869, 875 (2d Cir 1991).

It is of no consequence that [the debtor] attempts to characterize some of its state law claims as breach of contract, conversion and judiciary law violations because it is clear that all of those state law claims are founded upon some complaint about the quality of legal services provided by the [debtor's counsel] in connection with the Chapter 11 proceeding.

In re D.A. Elia Constr., 391 BR at 319 n 3.

Claims that meet the test of arising out of the same transaction and common nucleus of fact are precluded by res judicata regardless of whether the type or amount of damages differs in the second action, *Matter of Intellogic Trace, Inc.*, 200 F3d at 387-88; *Sure-Snap* at 875.

Here, plaintiffs were aware of the claims they now raise when they objected to Windels's fee application in the bankruptcy court. Plaintiffs raised and litigated substantially all of the factual issues concerning Windels's malfeasance and had ample opportunities to assert affirmative claims for recovery at the same time that they litigated their objections to Windels's conduct in the fee dispute. The fee dispute and the claims now before me share a common nucleus of operative fact, common evidence, and a common underlying transaction. Plaintiffs claims in this action are, therefore, barred by res judicata.

Accordingly, it is

ORDERED that the defendant's motion to dismiss the complaint is granted, and the complaint is hereby dismissed in its entirety, with prejudice, with costs and disbursements to defendant as taxed by the Clerk of the Court upon the submission of an appropriate bill of costs; and it is further

ORDERED that the Clerk is directed to enter judgment accordingly.

Dated: 7/8/10

ENTER:



J.H.O. **IRA GAMMERMANN**