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New Ethical Problems Arising in Bankruptcy Cases

(3 R's of Moment - - Retention, Reaffirmation and Rededication)

By

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THE THREE R'S OF MOMENT
(RETAINERS, REAFFIRMATIONS AND REDEDICATION)

Retainers, Review and Repayment (Disgorgement).

The recent case of *Stetler Cross Ministries, Inc. v. McDermott*[1] refocuses debtors' counsel upon the issue of retainers. A Chapter 11 case was filed on August 3, 2009. On August 15, 2009 a fee agreement was signed between the debtor and bankruptcy counsel. On August 17, 2009, bankruptcy counsel filed the required fee disclosure with the court under 11 U.S.C. 329 and FRBP 2016(b). Nine months later, the U. S. Trustee moved the court to require disgorgement of the fee. No fee application had been filed; no court order approving an attorney fee had ever been entered. The fee was not maintained in the debtor's counsel's escrow account. The case involved the nature of the retainer agreement and whether the funds were property of the estate. The bankruptcy court found that the retainer was property of the estate and that payment of the lawyer from the retainer was unauthorized. Disgorgement was ordered and the decision was upheld by the district court.

The retainer conundrum was fueled by dictum in *Lamie v. U. S. Trustee*[2]. The Supreme Court denied the request of debtor's counsel in a converted Chapter 7 for compensation from the estate. Addressing arguments that had been made concerning the need to compensate counsel for the valuable services that Chapter 7 counsel provided, Justice Stevens, writing for the majority stated:

> It appears to be routine for debtors to pay reasonable fees for legal services before filing for bankruptcy to ensure compliance with statutory requirements. See generally Collier Compensation, Employment and Appointment of Trustees and Professionals in Bankruptcy Cases P 3.02[1], p 3-2 (2002) ("In the majority of cases, the debtor's counsel will accept an individual or a joint consumer chapter 7 case only after being paid a retainer that covers the 'standard fee' and the cost of filing the petition"). So our interpretation accords with common practice. Section 330(a)(1) does not prevent a debtor from engaging counsel before a chapter 7 conversion and paying reasonable compensation in advance to ensure that the filing is in order. Indeed, the Code

> anticipates these arrangements. See, e.g., § 329 (debtors' attorneys must disclose fees they receive from a debtor in the year prior to its bankruptcy filing and courts may order excessive payments returned to the estate).[3]

One must determine the kind of retainer referenced by the Supreme Court in its term "standard fee". The ramifications are significant. If the retainer is a "security retainer" then it is property of the estate. If the retainer is a "classic", it is not. If the retainer is an "advance payment", then to the extent that the fee has been earned and paid to the lawyer, prior to the filing of the case, it is not property of the estate. However, until earned, it must be kept segregated from the lawyer's operating account[4] and may be subject to the trustee's demand for turn over.

Retainer agreements fall into three general categories: (1) classic retainers; (2) security retainers; and (3) advance payment retainers. The Fifth Circuit discussed the various types of retainer agreements and the effect that a bankruptcy filing would have on each:

> A classic retainer involves fees paid as consideration for employment of counsel, as opposed to compensation for services rendered. The classic retainer is earned in its entirety by counsel upon payment, and the debtor relinquishes all interest at remittance. A classic retainer, paid prepetition, is outside the estate and the purview of § 330, though it remains subject to disclosure and reasonableness review under § 329 of the Bankruptcy Code. A security retainer involves fees paid to counsel for prospective services. The debtor retains an interest in the funds until services are actually rendered. Pending the rendition of services, the attorney merely "holds" the funds for the debtor. Because the debtor retains an interest in these funds, they become property of the estate at filing subject to §§ 329 and 330. Finally, an advance payment or flat fee retainer involves fees paid as compensation for services to be rendered, but the payment passes entirely to counsel upon remittance, at which time the debtor relinquishes all interest. Funds collected as advance payment retainers do not become property of the bankruptcy estate at filing, and, as such, are subject to § 329 only. (internal citations omitted).[5]

In *Barron*, debtor's counsel had an extensive Chapter 13 practice. He routinely took four hundred dollar pre-petition retainers. His fee agreement outlined what pre-petition work would be done and that the retainer would be forfeited if no bankruptcy petition was filed. The court found

that this was an advance payment retainer and did not become part of the bankruptcy estate upon filing.[6] It should be noted that the Kentucky Supreme Court Rules allow for the designation of non-refundability in a written retainer agreement.[7]

In *Wagers v. Lentz & Clark, P.A.*[8], the debtor's counsel had obtained a $5,000 pre-petition retainer and an assignment of the client's tax refund. When the Chapter 7 was filed $1,000 remained in the retainer account. The tax refund was $50,000.00. Post-petition debtor's counsel supplied services valued at $13,000.00. The trustee objected to payment from the retainer alleging that the retainer was a "security retainer" and property of the estate. He pointed out that debtor's counsel had not been retained by the trustee. The court reluctantly agreed that despite the benefit that had been derived from counsel's assistance, no payment could be made.[9]

An "advance payment retainer" seems to more safely comply with the needs of debtor's counsel to be paid, prior to filing, a fee which reasonably represents the value of services. However, the distinction may be more academic that actual. SCR 3.130 (1.15 e) requires that money paid under a non-refundable retainer be deposited into the trust account until earned. Presumably, when we set our fees for a Chapter 7 case, we allocate some portion of the fee to post-petition matters such as attendance at the Section 341 meeting, the filing of the debtor education certificate and supplying documents to the trustee. If we maintain that the entire fee has been earned prior to filing, then are we representing our client during the balance of the case at no charge?

One commentator has urged that we consider categorizing our attorney/client relationships as executory contracts.[10] After filing, both the attorney and the client have duties yet to be performed. Arguably, any unearned funds in the retainer account could be treated like a security deposit with a landlord as a hedge against unpaid services.

After my review of these cases, it seems clear that time and consideration must be given to the drafting of retainer agreements with attention to potential challenges from trustees.

As we draft the agreement, we must determine what our "standard fee" encompasses. Is it permissible to delete representation in negotiating reaffirmation or redemption agreements, filing lien avoidance motions, appearing at Rule 2004 examinations or defending a client in a nondischargeability case?

Clear direction is given in Chapter 13. Western District of Kentucky Local Rule 2012 contains a non-exhaustive list of those duties which are included in the no look fee.[11] As to Chapter 7, Western District Local Rule 9011(1) requires that an attorney represent the client for all purposes throughout the case. Unbundling of services would not seem to be an option in the Western District.

If an advertisement includes reference to a specific fee amount for Chapter 7, then the attorney must file a description of the services which are included with the Kentucky Bar Association.[12]

Not withstanding the KBA's requirements and the local rules, our fee agreements should attempt to outline the scope of our services. Include a provision exempting the attorney from representation in a nondischargeability action. However, best practice requires that one move to withdraw from the case in the event a 523 or 727 action is filed, unless the client has the ability to supplement the fee.[13] Recall that legal maxim that we have all used - - a document is construed most strictly against its drafter. If we fail to be specific in limiting our representation, then no limits will apply.

Representation in reaffirmation matters may be one of the areas from which that we would like to insulate ourselves. Yet ridding oneself from unsecured debt to be better able to pay house and car payments is a constant theme among Chapter 7 debtors.

Reaffirmation to our Clients or to the System.

Called byzantine[14], obtuse[15], and bizarre[16] by judges, Section 524 poses an untenable dilemma for debtor's counsel. Congress has made us the gatekeeper for the court and required us to balance the need for reaffirmations against the primary bankruptcy objective of a fresh start. Meanwhile, our ethical mandates require us to vigorously pursue the client's objectives.

SCR 3.130(1.2) is clear. Lawyers must abide by their clients' decisions concerning the objectives of representation. The rule does not require us to agree with the clients' decisions, such as the advisability of entering into a reaffirmation agreement, but, according to 3.130(1.2), we must still be an advocate for client. Section 524 upsets this balance and places lawyers, not in advocate roles, but in judicial\paternalistic postures.[17]

It is helpful to look at the evolution of our gatekeeper duties. Congress came close to eliminating reaffirmations in the Bankruptcy Reform Act of 1978. The House version did not allow reaffirmations; the Senate convinced the House to compromise.[18] Under the version which became law, a court would allow the reaffirmation of a debt if the agreement was found to be in the best interest of the debtor, without posing an undue hardship on the debtor or a dependent of the debtor. The attorney was required to play no role but as a proponent for his or her client.

The amendment of the Bankruptcy Code which followed *Northern Pipeline Construction v. Marathon Pipe Line Co.*[19] included the provision that an attorney who represented the debtors during the negotiation of a reaffirmation agreement must certify that the agreement would not impose an undue hardship.

Most recently, as a part of BAPCPA[20], Congress required the attorney who represents a debtor in negotiating the reaffirmation agreement to determine: (1) does the reaffirmation agreement "impose an undue hardship on the debtor or a dependent of the debtor" and, (2) if the reaffirmation

creates a presumption of "undue hardship," can the debtor still make the "required payment" under the reaffirmation agreement? [21]

We may try to avoid this uncomfortable position by refusing to sign the reaffirmation agreement, but such inaction signals the court that a problem exists, thereby undermining our duty of loyalty to our client. Courts are divided as to whether representation in reaffirmation matters is so central to Chapter 7 work as to be a core service.[22] Since reaffirmations occur in twenty-five percent of cases[23], some courts have advised that lawyers who do not want to handle reaffirmations should avoid Chapter 7 practice altogether.[24]

When the requirements of attorney certification of negotiated reaffirmation agreements was initially instituted, there was concern that lenders might turn to debtor's counsel in the event of a post-petition default. This author has seen no evidence of such action. The greater risk may come from action brought by our clients.

Assume that one bows to client pressure and files a certificate that the payment does not create an undue hardship. If that certificate is untrue or misleading, or upon exercise of reasonable care should have been known to be untrue or misleading, then FRBP 9011 sanctions may apply. Further, 11 U.S.C. § 526(a)(2) may make us "debt relief agencies," liable to "assisted persons" (our clients) in the amount of "fees or charges in connection with providing bankruptcy assistance . . . for actual damages and for reasonable attorneys' fees and costs . . .". Documenting our files that we have advised the clients of the pitfalls of reaffirmation assumes heightened importance against such a back drop.

The best resolution of this reaffirmation quandary is through Congressional action to a return to the original intent of the Code to allow us to be advocates of our clients. A more achievable approach may be through local rules which create guidelines to which attorneys may point clients

and creditors, perhaps citing interests rates in excess of fifteen percent or personal property balances in excess of $20,000 as per se indicia of an undue hardship.

Rededication to Our Calling.

Despite the financial pressures, we need to take more time with our Chapter 7 cases. We should require clients to provide us with the trustee documents prior to filing their petition. Then we need to review those documents. One Chapter 7 trustee said that it was rare for him to get an asset case unless someone had made a mistake.

Reviewing bank statements for those large payments made on the eve of filing, looking at vehicle titles to be sure that liens are noted and reviewing schedules for accuracy will help prevent the mistake from being our own. In one case, failure to list a cause of action on Schedule B created a judicial estoppel which ultimately prevented the client from pursing a bad faith insurance claim.[25] The facts of that case strongly hinted that the client was not blameless; however, lay people do not use phrases like "cause of action" and "contingent claims". Probing questions are required to assist with the preparation of the petition.

It is hard for lawyers to turn away a client. However, that is often the best decision. If there are 707(b) matters and the client refuses to consider Chapter 13 or if there are Chapter 13 confirmation issues that the client will not address by surrendering a luxury item, then the best decision is to turn down the representation.

Lastly, we can not deal with clients as though they are commodities. Clients call us and expect that we will be with them throughout the process, including attendance at the 341 meeting. Habitually asking another lawyer, who has never seen the client and has no familiarity with the file does no service to the client or the bankruptcy system.

1. 2011 U.S. Dist. LEXIS 40901. This decision was filed on April 14, 2011 and may not yet be final.

2. *Lamie v. United States Trustee,* 540 U.S. 526; 124 S. Ct. 1023, 157 L. Ed. 2d 1024, 2004 U.S. LEXIS 824. The case did not hinge upon the construction of debtor's counsel's retainer, but upon Congress's then recent amendment to the Bankruptcy Code of Section 330(a)(1).

3. *Ibid* at 537.

4. See SCR 3.130(1.15).

5. *Barron v. Countryman,* 432 F.3d 590, 595; 2005 U.S. App. LEXIS 26640.

6. In *Barron,* the Eastern District of Texas had local rule that allowed debtor's counsel a fee of not more than $2,000.00 without a fee application. Barron took no more than $2,000.00 in each case, presumably including his $400.00 retainer.

7. SCR 3.130(1.5 f).

8. 514 F.3d 1021; 2007 U.S. App. LEXIS 28805.

9. The Tenth Circuit cited with approval CK Liquidation which noted that its decision "may place bankruptcy counsel in the difficult position of choosing between performing fiduciary obligations to clients despite the potential for nonpayment and risking professional malpractice claims." In re *CK Liquidation Corp.*, 343 B.R. 376, 385 (D. Mass. 2006).

10. Hon. William F. Stone and Bryan A. Stark, Esq., "The Treatment of Attorneys' Fee Retainers in Chapter 7 Bankruptcy and the Problem of Denying Compensation to Debtors' Attorneys for Post-Petition Legal Services, 82 Am. Bankr. L. J. 551, 567 (2008).

11. The "flat fee" includes, but is not limited to, the following services and responsibilities: (1) Meeting with clients prior to the filing of the bankruptcy petition; (2) Running a credit report to ensure that all debts are listed; **(3)** Gathering all documents necessary to comply with the Chapter 13 Order to the Debtors; **(4)** Preparing the Chapter 13 petition; **(5)** Preparing Official Form B22C, Statement of Current Monthly Income and Calculation of Commitment Period and Disposable Income; **(6)** Ensuring that the debtor(s) complete credit counseling; **(7)** Filing the petition, schedules, plan, matrix, and credit counseling certificate with the Court; **(8)** Filing a Motion to Extend the Automatic Stay, if necessary; **(9)** Filing a Motion to Strip Off Junior Lien, if necessary; **(10)** Escrowing pre-petition Chapter 13 plan payments for turnover to the Trustee at the Section 341 Meeting; **(11)** Reviewing all claims filed in the case prior to the Section 341 Meeting; **(12)** Attending the Section 341 Meeting - resolving objections to confirmation, representing the client, and working out any issues with the Chapter 13 Trustee so that the debtor and the trustee can present a confirmable plan to the Court; **(13)** Attending the Confirmation Hearing, if necessary; **(14)** Completing work necessary to amend the Order of Confirmation, if necessary; **(15)** Filing objections to claims, if necessary; **(16)** Performing responsibilities related to annual compliance with Local Bankruptcy Rule 6070-1(e); and **(17)** Taking required action regarding the debtors' discharge, including filing the Financial Management Course Certificate and the Certification of Plan Completion and Request for Discharge.

12. SCR 3.130(7.04).

13. *Under 11 U.S.C. 329(a) an additional fee disclosure must be filed each time that we receive additional compensation from the debtor.*

14. In re *Hart*, 402 B.R. 78 (Bankr. D. Del. 2009).

15. In re *Mendoza*, 347 B.R. 34 (Bankr. W. D. Tex. 2006).

16. In re *Minardi,* 399 B. R. 841 (N. D. Okla 2009).

17. This paternalistic note is present in *Jamo v. Katahdin Fed. Credit Union* (In re *Jamo*), 283 F.3d 392, 398 (1st Cir. 2002), in which the court wrote, "Because reaffirmation constitutes a debtor-invoked exception to the tenet that underpins the bankruptcy system - the 'fresh start' principle - a reaffirming debtor must be afforded some protection against his own (potentially) short-sighted decisions."

18. See S. Rep. No. 98-65, at 13 (1983).

19. 458 U.S. 50 102 S.Ct. 2858, 73L.Ed.2d 598 (1982).

20. Bankruptcy Abuse Prevention and Consumer Protection Act.

21. 11 U.S.C. §524(c).

22. Hon. Thomas Fulton is of the opinion that counsel can refuse to sign a reaffirmation agreement, without withdrawing from the case, but must attend the hearing and must assist the client in ongoing negotiation with the creditor, if the facts demand. Similarly, see In re *Riggs*, 2006 WL 2990218 (Bankr. Mo. W. D. Mo. Oct. 12, 2006) and In re *Goodman*, 2009 WL 936910 (Bankr. N. D. Ga. Apr. 6, 2009) in which the court allowed the lawyer to stay in cases without signing reaffirmation agreements.

23. According to Gregory Duhl, in his article, "Divided Loyalties: The Attorney's Role in Bankruptcy Reaffirmations", 84 Am. Bankr. L. J. 361, 401, twenty four per cent of Chapter 7 cases which closed in 2008 had at least one reaffirmation agreement.

24. Supra at 15.

25. *Music v. Arrowood Indemnity Co.,* 2009 U.S. Dist. LEXIS 116702 (Dist., E. D. Ky).