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Problematic Consumer Debtor Attorney's Fee Arrangements and the Illusion of "Access to Justice"

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The Supreme Court has recognized that under the Bankruptcy Code, the traditional payment model for attorneys representing individual consumer debtors in chapter 7 cases is straightforward: the attorney receives payment for the case in full, generally as a flat fee, prior to filing the case.[1] In recent years, however, attorneys, law firms, and third parties have sought to creatively reimagine the terms and methods of payment for representation of consumer chapter 7 debtors. Some of these alternative arrangements may run afoul of bankruptcy law and ethical obligations. As the statutory watchdog of the bankruptcy system,[2] the United States Trustee Program is acutely familiar with identifying these issues and, where appropriate, taking action to enforce the Code and redress the harms resulting from unethical and substandard practices.[3]

This article will first examine the legal and factual background for the creation of alternative consumer debtor attorney's fee arrangements. Next, the terms and potentially problematic features of some of the more common alternative arrangements the USTP has observed, including illegitimate schemes, fee-only chapter 13 cases, bifurcated fee agreements, and factored fees, will be discussed. Finally, the article will discuss the flawed "access to justice" arguments sometimes raised cynically by practitioners in defense of harmful and noncompliant fee structures.

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[1] *Lamie v. United States Trustee*, 540 U.S. 526, 537, 124 S. Ct. 1023, 1032 (2004) ("It appears to be routine for debtors to pay reasonable fees for legal services before filing for bankruptcy to ensure compliance with statutory requirements.").
[2] The United States Trustee Program has jurisdiction in all judicial districts except those in North Carolina and Alabama.
[3] 28 U.S.C. § 586(a)(3); *see also* H.R. Rep. No. 95-595, at 99 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6049 (United States Trustees "serve as bankruptcy watch-dogs to prevent fraud, dishonesty, and overreaching in the bankruptcy arena.").

Background

In contrast to chapters 11 and 13, the Bankruptcy Code is relatively silent as to payment of debtor attorney's fees in chapter 7 cases. Because chapter 7 debtor attorneys do not represent the estate, they are not employed under section 327 of the Code, nor may they receive compensation from the estate under section 330.[4] Nevertheless, bankruptcy courts retain the ability to review and reduce unreasonable or undisclosed compensation in chapter 7 cases under section 329 of the Code, and chapter 7 debtor attorneys' transactions with their clients are governed where applicable by sections 526, 527, and 528 of the Code.[5]

The automatic stay is imposed upon filing a voluntary petition.[6] With limited exceptions,[7] it bars collection of pre-petition debt during the pendency of the case. Pre-petition debtor attorney's fees are subject to both the automatic stay and discharge.[8] However, the Ninth Circuit Court of Appeals has held that fees owed for services rendered post-petition, even when based on a pre-petition contract, may be collected without running afoul of the stay or discharge.[9] The only other court of appeals that has addressed this question soundly rejected this approach.[10]

The realities of consumer debtor practice are also relevant. Defenders of alternative fee arrangements point quickly to filing numbers that have trended downward in recent years. True enough, the number of filings doubled between fiscal years 2007 to 2010 and then dropped to current levels that approximate the number of cases filed in 2007.[11] However, it also bears remembering that debtor

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[4] *Lamie*, 540 U.S. at 534, 124 S. Ct. at 1030. In contrast, the Code explicitly provides for payment from the estate to chapter 12 and 13 debtors' attorneys. 11 U.S.C. § 330(a)(4)(B); *Id.* at 540-41.

[5] *See* 11 U.S.C. § 526 (restrictions on debt relief agencies); *Milavetz, Gallop & Milavetz, P.A. v. United States*, 559 U.S. 229, 236, 130 S. Ct. 1324, 1331 (2010) (attorneys may qualify as "debt relief agencies.").

[6] 11 U.S.C. § 362(a).

[7] 11 U.S.C. § 362(b).

[8] *Rittenhouse v. Eisen*, 404 F.3d 395, 397 (6th Cir. 2005); *Bethea v. Robert J. Adams & Assocs.*, 352 F.3d 1125, 1129 (7th Cir. 2003); *Hessinger and Assocs. v. U.S. Trustee (In re Biggar)*, 110 F.3d 685, 688 (9th Cir. 1997).

[9] *Gordon v. Hines* (*In re Hines*), 147 F.3d 1185, 1191 (9th Cir. 1998).

[10] *Bethea*, 352 F.3d at 1128-29 (Noting that "the *Hines* majority wrote that it thought the Code as written . . . is unsatisfactory as a matter of public policy, and it decided to do a little surgery . . . *Hines* conceded that it was going against the Code's language" and holding that the *Hines* reasoning "is not enough to support that decision's holding.").

[11] *See* http://www.uscourts.gov/statistics-reports/caseload-statistics-data-tables. Fiscal years run from October 1 of the previous calendar year to September 30.

attorney's fees rose by about 45 percent following enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.[12]

Types of Arrangements

Consumer debtors in financial distress sometimes find it difficult to pay the chapter 7 attorney's fee in a lump sum prior to filing the bankruptcy case. Under the traditional model, such debtors who wish to be represented must either delay filing until the fees are paid in full (which may be infeasible in light of pending foreclosure sales or garnishments), or their attorneys must file the case without having received payment in full and with no recourse to compel payment of the balance. Alternative payment arrangements fall into three general categories: outright or potentially fraudulent schemes, fee-only chapter 13 cases, and bifurcated fee agreements (including "factoring" arrangements). In addition to the USTP, all stakeholders in the bankruptcy system should be committed to addressing the first category and vigilant in avoiding potentially problematic issues with the others.

Courts have found that some lawyers have engaged in schemes to obtain payment of their fees in illegitimate ways and in violation of the Code and Rules. A high-profile example was discussed in a recent article in this Journal summarizing a case regarding a national law firm's conduct decided in the Western District of Virginia.[13] In this case, which the USTP brought and which is on appeal, the bankruptcy court imposed sanctions after finding that the law firm engaged in a practice of referring clients to a towing company, which paid the clients' bankruptcy attorney's fees in exchange for taking possession of and in some cases selling the clients' vehicles by priming the lenders' secured claims. Fortunately, these sorts of attorney's fee payment arrangements are not typical, but extreme misconduct presents substantial risks to both participating attorneys and other stakeholders. In the example described above, the court found that lenders holding valid liens may have been harmed by loss of their collateral or by payment of exorbitant fees to recover the collateral. Moreover, the court found that debtors could have been exposed to legal risk, including breach of contract and possible violation of state law. Fee arrangements that are based on potentially fraudulent conduct have and will continue to draw the USTP's scrutiny and, where appropriate, enforcement action.

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[12] Lois R. Lupica, *The Consumer Bankruptcy Fee Study: Final Report*, 20 AM. BANKR. L. REV. 17 (2012).

[13] Roy M. Terry, Jr. and Elizabeth L. Gunn, *UpRight: A Cautionary Tale of a National Consumer Law Firm*, ABI JOURNAL, July 2018, at 32.

Another method of circumventing the Code's limitations on post-petition payment of chapter 7 attorney's fees which deserves further examination is the practice of placing debtors who are otherwise better served by chapter 7 in chapter 13 cases. In chapter 13, a significant portion of, or even all, attorney's fees can be paid over time under the debtor's plan.[14] This practice has a number of possible disadvantages. Fees in chapter 13, even for "no money down" chapter 13 cases, may be substantially higher than in chapter 7, meaning that these debtors pay more for the same relief they could more easily (and quickly) obtain in chapter 7.[15] Chapter 13 imposes greater obligations on debtors, including requirements to propose, obtain confirmation of, and fund a plan that under the Code must run for a minimum term of 36 months. And even if the goal is to convert the case to chapter 7 once the attorney's fees have been paid, the debtor may run the risk of having the case dismissed for bad faith without obtaining the ultimate benefit for which bankruptcy relief was sought: a discharge. Finally, filing chapter 13 cases in which the prospect for confirmation of, and successful compliance with, a plan is doubtful imposes additional burdens on bankruptcy courts and chapter 13 trustees.

Another recent article in the ABI Journal focused on the virtues of "bifurcation," the practice by which an attorney representing a consumer debtor in a chapter 7 bankruptcy case charges for their services under the color of two fee agreements.[16] This practice also merits scrutiny. Under the first "pre-petition" agreement, the debtor pays a nominal or no fee for work performed on the case prior to filing, such as consultation and the completion and filing of "skeletal" paperwork. After filing the skeletal case, the debtor and attorney enter into a second, "post-petition" agreement, which covers not just usual post-petition services (such as representation at the section 341 meeting and reaffirmations), but also preparation and filing of the schedules, statement of financial affairs, and other required documents. By structuring the fee agreement this way, the attorney purports to avoid creating an unperformed pre-petition contract that would be subject to the automatic stay and discharge.

Bifurcation – particularly in "$0 down" models – is prone to creating a fiction under which pre-petition services are severely undervalued so that the fees for those services can be shifted to the post-petition, non-stayed, non-dischargeable fee

[14] 11 U.S.C. § 330(a)(4)(B).

[15] Katherine M. Porter, Pamela Foohey, Robert M. Lawless, and Deborah Thorne, *'No Money Down' Bankruptcy*, 90 S. CAL. L. REV. 1055, 1077 (2017).

[16] Daniel E. Garrison, *Liberating Debtors from "Sweatbox" and Getting Attorneys Paid*, ABI JOURNAL, June 2018, at 16.

agreement, or actually eliminating the critical analysis and consultation that a competent attorney should provide prior to the debtor's decision to file. With the possible exception of the Ninth Circuit (due to *Hines*), it is likely impermissible to evade discharge of unpaid fees for pre-petition work by characterizing them as post-petition fees; moreover, fees charged pursuant to a post-petition contract for pre-petition services are unreasonable under section 329(b) of the Code. Further, while proponents of bifurcation emphasize that the debtor's entry into the post-petition agreement is completely independent of the pre-petition agreement and that the debtor could choose to proceed *pro se* or with other counsel for post-petition services, this "choice" may be illusory. The debtor and attorney go into the bifurcated case with the mutual expectation that the attorney will continue representation post-petition, and proceeding either *pro se* or with substitute counsel is difficult and unlikely.

Bifurcation has further evolved into a new practice, "factoring." Under a typical factoring model, the debtor's attorney bifurcates fees as described above, often advertising "$0 down," meaning no fees under the pre-petition contract. Once the case has been filed, the attorney has the client execute the post-petition agreement along with an agreement authorizing a third-party finance company to make automatic periodic debits for the fees due under the post-petition contract. The attorney then assigns the right to collect from the debtor under the post-petition agreement to the third-party finance company in exchange for a lump sum discounted payment, perhaps 70% of the face value of the post-petition contract. Going forward, the finance company has the right to collect payments from the debtor and to take collection action, including to sue and garnish, should the debtor default.

The additional gloss of factoring raises further concerns. Aside from the concerns inherent in bifurcation, factoring may promote unjustifiable inflation of the attorney's fees to make up for the discounted lump sum the attorney will receive from the finance company. In essence, this may be an undisclosed interest or finance charge. In some cases, the client may not have given fully informed consent to the fee arrangement. Further, the factoring arrangement may not be fully disclosed in the attorney's fee disclosure (Form 2030) or in the schedules.[17] The USTP is currently litigating enforcement actions in several bankruptcy courts and will continue to investigate and take action as appropriate when debtor's attorneys

[17] At a minimum, ongoing payments to the finance company on account of the post-petition fees ought to be listed as an expense line item on the debtor's Schedule I/J.

engage in this sort of conduct in a manner that violates the Bankruptcy Code and Rules.[18]

Is Access to Justice for Debtors or Their Lawyers?

USTP Director Cliff White recently stated that "too often, the phrase 'access to justice' is misused to excuse bad lawyering, or to justify twisting the Bankruptcy Rules for the financial gain of the lawyers."[19] "Access to justice" has become a common phrase in consumer bankruptcy commentary. It generally connotes concern for the ability of consumers in financial distress to access the bankruptcy system, and it is linked to suggested barriers to entry such as the availability of attorneys in rural areas and financial considerations, including the cost of hiring counsel and the terms under which they may be paid.

There may be legitimate concerns about the ability of "honest but unfortunate" consumer debtors to successfully file bankruptcy cases. All stakeholders in the bankruptcy system should be vigilant that the system is functioning as intended for the benefit of debtors and creditors. But too often, the USTP has seen "access to justice" used as a catchphrase to conceal and legitimize schemes designed to benefit professionals. And as described above, these schemes may come at the expense of the debtor and the true goal of the consumer bankruptcy system – the debtor's fresh start.

Two truths must be understood and followed in order to maintain a fair and effective consumer bankruptcy system. First, the economic concerns of consumer lawyers must never trump professional obligations. And second, "access to justice

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[18] On September 4, 2018, the Bankruptcy Court for the Northern District of Oklahoma entered an opinion and judgment in favor of the United States Trustee against a consumer debtor attorney using a factoring business model. *In re Wright,* No. 17-11936-M (Bankr. N.D. Okla. Sept. 4, 2018). The court found serious deficiencies in the attorney's conduct, notably that the attorney charged a higher fee to clients using the factoring model than charged to his "conventional" clients. The attorney admitted that in several cases he designated fees for pre-petition services as post-petition, which the court described as "a fraud both on the debtor and the Court." And the court found that the attorney's fee disclosures were "grossly misleading and indicative of a wanton disregard—*to the point of negligence*—for the level of candor required under § 329." (emphasis in original). The court ordered the attorney to disgorge all fees, voided the "post-petition" agreements, and barred the attorney and the factoring company from collecting any additional fees, in 17 cases.

[19] Clifford J. White III, Director, United States Tr. Program, Remarks at the 53rd Annual Seminar of the National Association of Chapter 13 Trustees (June 28, 2018).

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should be about the client. Period."[20] As it has for years, the USTP will continue to investigate and take enforcement action to end harmful substandard practice and misconduct by consumer attorneys.

[20] *Id.*