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Consumer Corner

By Daniel E. Garrison

Liberating Debtors from "Sweatbox" and Getting Attorneys Paid

Bifurcating Consumer Chapter 7 Engagements

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Consumer debtors should have affordable and immediate access to bankruptcy without compromising their attorney's ability to be paid. However, unlike chapter 13, a chapter 7 attorneys' fees are not an administrative expense, and attorneys fear that unpaid, pre-petition fees are subject to the automatic stay and discharge. Accordingly, attorneys traditionally enter into pre-petition, "earned-on-receipt" engagements with chapter 7 debtors, and are paid in full before commencing the case.

Unfortunately, this traditional fee structure increasingly threatens the fundamental premise of bankruptcy. In 1877, the U.S. Supreme Court observed that consumer bankruptcy's purpose is to give a fresh start to the "honest but unfortunate debtor."[1] However, a fresh start is now becoming less attainable for many debtors because the traditional approach limits access to counsel and delays filing.

Increasingly, attorneys solve this problem by offering low- or $0-down terms to chapter 7 clients and bifurcating the engagement (splitting pre-petition and post-petition services into separate agreements to allow post-petition payments for post-petition work).[2] Despite its increasing prevalence, some remain skeptical on whether bifurcation is allowed under existing law. In fact, courts that have examined bifurcation either have approved it or noted its permissibility when done correctly.[3]

The Problem

Unsurprisingly, debtors in financial distress struggle to pay attorneys before obtaining the benefit of the automatic stay, particularly as chapter 7 attorneys' fees have climbed precipitously in recent years.[4] Consequently, debtors wait longer to file despite crushing financial pressure; more debtors file their cases *pro se*, creating burdens on the system; and some attorneys push clients toward "fee-only" chapter 13 cases as a way to provide debtors with immediate relief and post-petition payment terms.

Forcing debtors to languish in financial distress threatens their fresh start. In a forthcoming law review article by the co-investigators of the Consumer Bankruptcy Project (CPB),[5] they compare recent consumer/debtor data to earlier periods, concluding that consumers are spending longer than ever in the financial "sweatbox" before filing.[6] In so doing, debtors are "depleting assets [that are] key to building their post-bankruptcy lives," rendering the chance of their achieving a fresh start "even more tenuous."[7] "Long strugglers" (who languish for two or more years) end up losing their homes and selling other property, and have reported going without food and other necessities.[8] They also commonly arrive in bankruptcy with lower exempt assets and higher debts,[9] suggesting that the "sweatbox" adversely also affects creditors.

If debtors eventually file *pro se*, they have a far lower chance of achieving a fresh start than

1 *See, e.g.*, Margaret Howard, "A Theory of Discharge in Consumer Bankruptcy," 48 *Ohio St. L. J.* 1047 and n.1 (1986).
2 Hon. Robert E. Ginsberg and Hon. Robert D. Martin, *Ginsberg & Martin on Bankruptcy*, § 4.05[E] (Aspen Publishers 2008).
3 *See infra*.
4 Lois R. Lupica, "The Consumer Bankruptcy Fee Study: Final Report," 20 *ABI Law Review* 17, 30 (Spring 2012), *available at* abi.org/member-resources/law-review (unless otherwise specified, all links in this article were last visited on April 30, 2018).
5 Pamela Foohey, Robert M. Lawless, Katherine M. Porter and Deborah Thorne, "Life in the Sweatbox," *Notre Dame L. Rev.* (forthcoming 2018), *available at* www.creditslips.org/creditslips/2018/02/peoples-pre-bankruptcy-struggles-new-paper-from-consumer-bankruptcy-project.html.
6 *Id.* at 1.
7 *Id.* at 4-5.
8 *Id.* at 2.
9 *Id.* at 23-24.

their represented counterparts. In their article, the CPB investigators noted that virtually all represented debtors obtain discharges, while more than 29 percent of *pro se* debtors fail to achieve a "fresh start."[10] *Pro se* debtors also disproportionately burden the system, requiring judges, trustees and staff to devote extra time and resources.[11] All of this is for naught, though, if a *pro se* debtor fails to receive a discharge.

Affordable representation and quicker relief clearly serve the system's purpose. However, one ill-conceived solution to this problem is the use of so-called "fee-only" chapter 13 plans. In order to offer post-petition payment terms, some attorneys convince debtors to file chapter 13 cases, knowing that the debtor's plan will only satisfy fees.[12] Chapter 13 fees are higher than chapter 7 fees,[13] and chapter 13 cases are more burdensome on the system, and discharge rates are alarmingly lower than under chapter 7.[14] Unfortunately, the availability of post-petition payment terms remains a powerful inducement for debtors to choose chapter 13 where payment terms are not available for chapter 7.[15]

No one should hold their breath waiting for Congress to amend the Bankruptcy Code. It has been two decades since the Ninth Circuit commented on the problem in *Gordon v. Hines*,[16] and Congress has not acted:

> [B]ecause Congress has failed to correct that oversight in express terms, we are compelled to consider an appropriate judicial response — one that recognizes that the very administration of the bankruptcy system requires that attorneys for Chapter 7 debtors must have a legally enforceable right for their post-petition services that were contracted for before filing of the petition. *If the absence of such a right were to become the law, it does not require much thought to recognize that the entire system would suffer a massive breakdown*.[17]

While the *Hines* court adopted a *quantum meruit* solution to allow the post-petition collection of fees,[18] bifurcation offers a more direct and sensible solution that is consistent with the Code and existing case law — and therefore does not require Congress to act.

The Solution: Bifurcation

The viability of bifurcation is obvious when placed into the context of well-accepted practices. No one questions that a debtor can pay for post-petition legal services with post-petition earnings.[19] Consequently, a consumer could use a document preparer or draft their own petition, and later hire and pay an attorney. Likewise, a debtor could hire one attorney to file the case, then replace that attorney with another after filing. In each situation, an attorney is retained and paid post-petition for providing all required chapter 7 services beyond filing a "naked" petition. Bifurcation should not be treated differently.

One might well ask why it is preferable to allow a debtor to use pre-petition assets to *pre-pay* for services that indisputably will be rendered post-petition. Attorneys arguably do not have an enforceable right to payment until services are rendered,[20] leading at least one court to order disgorgement of a sizeable, "earned-on-receipt" retainer to defend an anticipated nondischargeability claim.[21]

A debtor's circumstances sometimes require that a petition be filed quickly, leaving a good portion of the work in the case to be done post-petition. Some bifurcation critics have suggested that filing a "naked" petition is only permissible in exigent circumstances, but this is belied by the black-letter text of Rule 1007. Only a limited number of items must be filed with the petition, and the "schedules, statements and other documents required by subdivisions (b)(1), (4), (5), and (6)" could "be filed with the petition *or* within 14 days thereafter," except as otherwise provided in the rule.[22] Likewise, the financial-management course certification might be filed within 60 days after the first meeting of creditors (which also occurs post-petition).[23] Finally, all of these post-petition deadlines can be extended at the court's discretion.[24] Any argument that this work must be completed prior to the petition date is unsupportable — and when debtors are in the "sweatbox," it is patently against their interest to artificially increase the waiting time for relief.

Thus, the narrow question is whether the *same attorney* can represent the debtor both before and after the filing of the petition under separate agreements, and be paid for post-petition work from post-petition earnings or other non-estate assets. The answer is an unequivocal "yes."

Despite the Bankruptcy Code lacking an explicit reference, courts have issued well-reasoned, thoughtful decisions approving bifurcation or noting its viability if done correctly. These decisions distill the requirements to certain key elements.

First, there must be legitimate pre-petition and post-petition engagement agreements. Second, the post-petition fee must be reasonable for the post-petition work, which must be competently performed. Finally, the attorney must obtain the debtor's informed consent after appropriate disclosures, including the options to a bifurcated engagement.

In one such case, *Walton v. Clark & Washington PC*,[25] a bankruptcy court approved a bifurcated engagement that involved a separate, post-petition agreement with post-petition payment terms. At the court's urging, the firm adopted disclosures describing the client's options for post-petition legal services: "(i) the client can proceed *pro se*, (ii) the client can retain [the firm], or (iii) the client can retain another firm."[26] Determining that this two-contract process is consistent with the Code, the *Walton* court quoted the Seventh

10 *Id.* at 8, n.34, and 10, n.53.

11 *See* Lois R. Lupica and Nancy B. Rapoport, "Best Practices for Limited Services Representation in Consumer Bankruptcy Cases," *ABI National Ethics Task Force Final Report* (April 21, 2013), *available at* abi-org-corp.s3.amazonaws.com/materials/Final_Report_ABI_Ethics_Task_Force.pdf.

12 *See* Katherine M. Porter, Pamela Foohey, Robert M. Lawless and Deborah Thorne, "No Money Down Bankruptcy," 90 *S. Cal. L. Rev.* 1055, 1058.

13 Noting an average chapter 7 fee of $1,229, as opposed to an average chapter 13 fee of $3,217. *Id.* at 1058 and n.10.

14 *See id.* at 1060.

15 *See id.* ("[C]hapter choice is powerfully shaped by when debtors must pay their attorneys and how attorneys can receive payments.").

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

17 *Id.* at 1190-91 (emphasis added).

18 *See id.* at 1191-92.

19 *See, e.g., Walton v. Clark & Washington PC (In re Walton)*, 469 B.R. 383, 386 and n.13 (Bankr. M.D. Fla. 2012) (citing *Lamie v. Trustee*, 540 U.S. 526, 535-36 (2004)).

20 *See, e.g., In re Mansfield*, 349 B.R. 783, 791-92 (Bankr. E.D. Pa. 2008).

21 *See In re Boates*, 551 B.R. 428 (B.A.P. 9th Cir. 2016).

22 Fed. R. Bankr. P. 1007(c).

23 *Id.*

24 *Id.*

25 454 B.R. 383 (M.D. Fla. 2012).

26 *Id.* at 385-86.

Circuit Court of Appeals that "debtors 'who cannot pay in full can tender a smaller retainer for pre-petition work and later hire and pay counsel once the proceeding begins — for a lawyer's aid is helpful in prosecuting the case as well as in filing it.'"[27]

The court also rejected the U.S. Trustee's argument that the bifurcated agreement left the debtor without counsel during a "cooling-off" period between the filing and date of the post-petition agreement, noting that "[u]nder the modified two-contract procedure, the firm agrees to continue representing the client ... until the Court enters an order allowing the firm to withdraw."[28] The *Walton* court concluded, "In the end, there is no prohibition against a debtor making post-petition installment payments for post-petition services."[29]

Another bankruptcy court approved a very similar structure.[30] In *Slabbinck*, the debtor also executed two separate agreements, and the court rejected an argument by the U.S. Trustee that "the Pre-Petition Agreement and the Post-Petition Agreement are essentially a single, pre-petition agreement giving rise to an entirely pre-petition debt."[31] The court similarly rejected an argument that the firm could not legally "unbundle the legal services that it would perform for the Debtors into pre-petition and post-petition services," noting that this argument had no basis in the Code or controlling law.[32]

In other cases, courts have disallowed particular fee structures, but also described how a properly structured bifurcation is permissible. In *Mansfield*, a Pennsylvania attorney utilized a traditional, pre-petition "flat-fee" engagement structure, but tried to collect fees after the case had been filed.[33] Although ultimately prohibiting the attorney's post-petition collection, finding that a "flat-fee" contract could not be judicially bifurcated,[34] the court noted that if there is a separate, post-petition agreement, bifurcation is allowed.[35] Another bankruptcy court had similarly opined that a separate post-petition contract for post-petition services was enforceable, despite disallowing a nonconforming arrangement in the case under review.[36]

The post-petition fee must be reasonable, but in a bifurcated case (and especially where post-petition installment terms are offered), "reasonability" must take into consideration very different circumstances than a traditional case. Bifurcation takes additional work, as the documentation is more intensive and an attorney must take on at least one additional client meeting.

Disclosures are also more numerous and complicated. Where payment terms are offered, an agreement must be negotiated for the amount, timing and duration of those payments. Moreover, there is additional work and risk in accepting installments over many months. Where attorneys obtain financing to assist with cash flow and payment administration, there may be direct financing costs.

However, a higher fee might be more attractive than any other alternatives available to the debtor. For example, the alternative to post-petition payment terms might be to live with a continuing garnishment. A minimum-wage earner working 30 hours per week meets the minimum threshold to be garnished at the federal maximum of 25 percent of gross wages, resulting in monthly garnishment of more than $235. If a $2,000 fee is paid in 12 monthly installments, the monthly payment is significantly lower (about $167 per month), and those payments will end in 12 months, whereas a garnishment might not. So long as all of this is made plain to the debtor, the law supports them choosing what is best for them.

One last objection to bifurcation seems to be the concern with "unbundling" typical chapter 7 services. This well-intentioned concern that attorneys might mislead unsophisticated and vulnerable debtors into limited engagements that are not in their best interest is misplaced in the bifurcation scenario. In bifurcation, the attorney's intention is not to *limit* the scope of the engagement, but rather to *split* it into its pre- and post-petition components and offer post-petition payment terms. Just as a debtor could choose to use a document preparer or prepare his/her own petition, then hire counsel, they should be allowed to choose to hire the same attorney in a bifurcated engagement.

Obviously, this choice requires informed consent after robust disclosure. At a minimum, attorneys should disclose (1) the scope of the pre-petition services, (2) the existence of options to the post-petition engagement, (3) the risks of proceeding *pro se*, (4) whether the post-petition installment option involves a higher fee than if the debtor paid in cash, and (5) that the attorney will remain counsel of record in the case until and unless the court allows withdrawal.

Conclusion

Preventing debtors from taking advantage of a bifurcated engagement and post-petition payment terms where adequate disclosures have been made serves no valid purpose and instead hurts the entire bankruptcy system. In fact, there is no case law disallowing the practice, and well-reasoned decisions have supported it.

Bifurcation and access to post-petition payment terms provides an escape from the "sweatbox," allows attorneys to be paid post-petition and to access working-capital financing solutions, and mitigates the systemic burdens created by *pro se* debtors. Such a "win-win" scenario is too rare an occurrence to ignore. abi

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27 *Id.* at 386 (quoting *Bethea v. Robert J. Adams & Assoc.*, 352 F.3d 1125, 1128 (7th Cir. 2003)).
28 *Id.* at 387.
29 *Id.*
30 *See In re Slabbinck*, 482 B.R. 576 (Bankr. E.D. Mich. 2012).
31 *Id.* at 583.
32 *Id.*
33 *See In re Mansfield*, 394 B.R. 783 (Bankr. E.D. Pa. 2008).
34 *See id.* at 791.
35 *Id.* at 792-93.
36 *See In re Griffin*, 313 B.R. 757, 769-70 (Bankr. N.D. Ill. 2004).