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There's No Such Thing as Too Much Information

Disclosure of Bifurcation and Financing in Chapter 7 Cases

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In several jurisdictions across the nation — notably, California, Oklahoma, Missouri, Idaho, Maryland and Utah — U.S. Trustees have challenged attorneys who bifurcate chapter 7 case attorneys' fees into pre-petition and post-petition, and allow their clients to pay fees in post-petition installments. Following the petition filing, an attorney has a duty to disclose such compensation pursuant to 11 U.S.C. § 329(a) and Rule 2016(b) of the Federal Rules of Bankruptcy Procedure. However, in each bifurcation fee-agreement case, the attorneys in question might also have had a factoring relationship with a third party and delegated management of the debtors' payments to the factor in order to manage the business challenges of offering clients post-petition payment plans. Therefore, one of the primary arguments made by the U.S. Trustee challenging these disclosures has been that court disclosures of the bifurcation and financing have been inadequate or misleading. This article suggests an approach to disclosing these matters fully using a modified version of Form B2030 (the "Disclosure of Compensation of Attorney for Debtor").

Background

A bifurcation fee agreement involves splitting a consumer chapter 7 engagement into two written agreements. The debtor signs the first agreement pre-petition, and it covers the minimum fee required to commence the case. The debtor signs the second agreement post-petition, and that fee covers the remaining work necessary to complete the case. Attorneys often waive their pre-petition fees in order to offer a true "$0-down" filing to clients, but some simply split their total fees between the two agreements and collect a portion before filing the case. Attorneys who bifurcate the attorneys' fees commonly offer payment terms for their post-petition fees.[1]

The primary business challenges to attorneys (especially "small-shop" operations) of offering $0-down chapter 7 are usually cash flow strain and lack of capacity to manage installment payments. Accordingly, a few companies have entered the market to provide attorneys with a "turn-key" solution to these challenges, including working-capital financing, payment management and related services.

Some of these companies offer factoring arrangement, whereby the attorney sells the client receivable to the factor at a discount, and the factor then collects the balance from the client for the factor's own benefit and at its sole risk and with no recourse from the attorney.[2] Even where the financing does not take a form of a factoring arrangement, the attorney must draw against a secured line of credit a percentage of the amount of post-petition fees owed by each client, with the lender keeping the difference as its compensation for the financing, payment management, credit reporting and other services that might be offered. In either the factoring or financing-arrangement scenarios, the attorney receives funding from the lender, and the lender takes on payment management responsibilities, thereby solving the attorney's primary business challenges of bifurcating the chapter 7 case attorneys' fees.

1 For an explanation of the practice and legitimacy of bifurcating consumer chapter 7 attorneys' fees, *see* Daniel E. Garrison, "Liberating Debtors from 'Sweatbox' and Getting Attorneys Paid: Bifurcating Consumer Chapter 7 Engagements," XXXVII *ABI Journal* 6, 16, 66-68, June 2018, *available at* abi.org/abi-journal; *see also In re Hazlett*, Case No. 16-30360, 2019 WL 1567751 7-11 (Bankr. D. Utah April 10, 2019).

2 *See, e.g.*, "Factoring (finance)," Wikipedia, *available at* en.wikipedia.org/wiki/Factoring_(finance) (unless otherwise specified, all links in this article were last visited on May 20, 2019).

Current Disclosure Requirements and Form B2030

Section 329 of the Bankruptcy Code provides that "[a]ny attorney representing a debtor ... whether or not such attorney applies for compensation ... shall file with the court a statement of the compensation paid or agreed to be paid ... and the source of such compensation."[3] Section 329 is implemented through Bankruptcy Rule 2016(b), which requires that the attorney file "the statement required by § 329" and disclose "whether the attorney has shared or agreed to share the compensation with any other entity ... includ[ing] the particulars of any such sharing or agreement."[4] The requirement to disclose fee-sharing relates not to § 329 but instead to § 504, which is discussed below. Other than this additional requirement to disclose fee-sharing, Rule 2016(b) does not add substantive disclosure requirements beyond § 329's mandate.

In turn, Bankruptcy Rule 9009 governs the promulgation and use of bankruptcy forms. "Official Forms" are prescribed by the Judicial Conference, and "Director's Forms" are issued by the Director of the Administrative Office of the U.S. Courts (AOUSC).[5] Pursuant to Rule 9009(c), both types of "forms shall be construed to be consistent with the ... rules and the Code."[6] The use of Official Forms is mandatory, and only specified changes to them are allowed.[7] However, "[i]n contrast to Official Bankruptcy Forms," however, "the use of Director's Bankruptcy Forms is permissive. Director's Forms have been created by the [AOUSC] for the benefit of bankruptcy case participants *and may be modified to fit the needs of the user*."[8]

Form B2030 is a Director's Form, and its use is discretionary.[9] Even in districts where local rules require the use of Form B2030, the common practice is to allow changes that do not alter the fundamental format and purpose of Form B2030.

Problems with and Recommended Uses of Form B2030 for Bifurcation and Chapter 7 Attorney-Fee Financing

As a Director's Form, Form B2030 easily can be adapted for use in a bifurcated chapter 7 attorney-fee case where counsel borrows from a lender an amount to cover attorney compensation and delegates management of debtors' payments toward that compensation to that lender. With the modest adaptations recommended below, the common arguments about insufficient or misleading disclosures in bifurcated and financed attorney fee cases could be resolved.

Section 1 and the "Agreed to Accept" Argument

Section 1 of Form B2030 is the basic financial disclosure concerning an attorney's compensation. Oddly enough, Section 1 contains language that does not track the language of either § 329 or Rule 2016(b) because it purports to require counsel to indicate what dollar amount they have "agreed to *accept*" for legal services.[10] In contrast, § 329 requires counsel to provide "a statement of the compensation *paid or agreed to be paid*."[11] The notion of what counsel has agreed to "accept" has no basis in § 329, and Rule 2016(b) requires only "the statement required by § 329."[12] Why Form B2030 contains this anomalous language is a bit of a mystery.

> **Because Form B2030 is a Director's Form, it should be modified to assist counsel in fulfilling these disclosure duties.**

This seemingly innocuous difference has spawned an argument in the world of attorney-fee bifurcation agreements. Where a chapter 7 attorney bifurcates the fee and utilizes a financing solution structured so that the attorney effectively receives only a percentage of the fee that a debtor has agreed to pay, some U.S. Trustees have argued that a disclosure of the amount that the debtor has agreed to *pay* is false or misleading because counsel has agreed to *accept* only the amount advanced to them by their lender. Of course, this conflates two completely different concepts.

What a debtor has agreed to pay and what counsel can borrow from a lender against the receivable are entirely different matters. Regardless, § 329 does not require a disclosure of what *counsel is willing to accept*; it instead requires a disclosure of what the *debtor has agreed to pay*. Because Form B2030 is a Director's Form, it may be modified to track the statute and moot this argument.

All that remains then is to accurately portray the nature of a bifurcated fee case in this section of Form B2030. Counsel who bifurcates a chapter 7 engagement should list the total amount that a debtor has agreed to pay for services (under both the pre- and post-petition agreements), the amount (if any) that counsel has received prior to the disclosure, and, finally, the "balance due." However, counsel who uses a third-party payment-management service should take care to investigate whether a debtor has made any post-petition payments before counsel files the Form B2030. Otherwise, the amount listed in response to the query "[p]rior to the filing of this statement I have received" actually might be incorrect and misleading. In most bifurcated-fee cases, and so long as Form B2030 is filed within 14 days after the petition, the amount paid pre-petition (if any) and the amount paid prior to filing the Form B2030 will be the same.

Section 4 and the Fee-Sharing Argument

Section 4 of Form B2030 has become the focus of another argument in bifurcated-fee cases where counsel uses a financing solution. Because in the typical financed attorney-fee transaction the attorney receives only a percentage of the debtor's post-petition fee, some argue that counsel are in fact fee-sharing with the lender. In terms of disclosure, those who make this argument contend that counsel must either check

3 11 U.S.C. § 329(a).
4 Fed. R. Bankr. P. 2016(b).
5 *See* Fed. R. Bankr. P. 9009(a), (b).
6 *See* Fed. R. Bankr. P. 9009(c).
7 *See* Fed. R. Bankr. P. 9009(a); *see also* "Permitted Changes to Official Bankruptcy Forms," U.S. Courts, *available at* uscourts.gov/rules-policies/about-rulemaking-process/permitted-changes-official-bankruptcy-forms.
8 *Id.* (emphasis added).
9 *See* "Disclosure of Compensation of Attorney For Debtor," U.S. Courts, *available at* uscourts.gov/forms/bankruptcy-forms/disclosure-compensation-attorney-debtor-0.
10 Fed. Bankr. Form B2030 (emphasis added).
11 11 U.S.C. § 329(a) (emphasis added).
12 Fed. R. Bankr. P. 2016(b).

the box in section 4 denying fee-sharing, or check the box admitting it — either of which, they argue, is fatal.

First, this argument misunderstands the purpose of the fee-sharing disclosure in a Form B2030. As previously noted, § 4 of Form B2030 exists because Rule 2016(b) also implements § 504, which provides that (with exceptions) "a person receiving compensation or reimbursement under section 503(b)(2) or 503(b)(4) ... may not share or agree to share ... any such compensation or reimbursement with another person."[13] By limiting this prohibition to counsel subject to § 503, chapter 7 attorneys are categorically excluded because their fees have no administrative status.[14] From this perspective, there is an argument that the disclosure is inapplicable to chapter 7 attorneys, or that checking "no" in response to the question is defensible, so long as that response is interpreted to mean "I am not out of compliance with § 504."

Moreover, § 504 prohibition has no relation to the type of fee-sharing prohibition that is universally prohibited (*i.e.*, sharing fees with non-lawyers). Section 504 is more restrictive and prohibits fee-sharing among unassociated attorneys — *even with the client's knowledge and consent*, which is an accepted practice outside of bankruptcy. The purpose of the fee-sharing disclosure in Form B2030 is to police the requirements of § 504, not to ask whether counsel is engaging in a practice that is prohibited in all 50 states.

Regardless, Rule 2016(b) plainly requires disclosure of "whether the attorney has shared or agreed to share the compensation with any other entity," including "the particulars of any such sharing or agreement."[15] The question then arises as to whether chapter 7 financing constitutes a prohibited fee-sharing. The answer to this quandary is not always clear. A typical factoring relationship might constitute a prohibited fee-sharing in some states; on the other hand, a recourse financing relationship does not.

Model Rule of Professional Conduct 5.4(a) provides that (subject to three inapplicable exceptions) "[a] lawyer or law firm shall not share legal fees with a nonlawyer."[16] Because a lawyer's revenue typically is fees, they "share" fees (in a common sense) with everyone: employees, vendors and lenders (even, ironically, the state bar). Recognizing this situation, one well-reasoned ethics opinion observed that "[t]he rule is not implicated simply because the lawyer's payments to a funder come from income derived from legal fees."[17] Instead, what Rule 5.4(a) prohibits is an arrangement whereby "the lawyer's future payments to the funder are contingent on the lawyer's receipt of legal fees or on the amount of legal fees received in one or more specific matters."[18]

Accordingly, a factoring arrangement might constitute a prohibited fee-sharing scheme because the factor assumes the risk of loss and is paid only to the extent that it collects the actual legal fees. In contrast, recourse financing — even where the client receivables are pledged as collateral — does not present the same challenge because the attorney is the borrower in this relationship and must repay the debt regardless of whether the client pays the attorneys' fees.[19]

Turning then to the disclosure requirement in Form B2030, a chapter 7 attorney using a factoring arrangement is likely fee-sharing in violation of Rule 5.4(a) and is on the horns of a dilemma: Fail to disclose, or disclose and face scrutiny for the prohibited fee-sharing? Counsel using recourse financing are not fee-sharing, so no disclosure is required.

Adding Disclosures

To be complete and accurate, attorneys who bifurcate and finance chapter 7 attorneys' fees ought to make additional disclosures that are not provided for in Form B2030. This can easily be done in § 6 above the signed certification. As to fee bifurcation, a robust disclosure might read as follows:

> Debtor and counsel have entered into two, separate fee agreements:
>
> a. The pre-petition agreement provided for preparation and filing of the petition, creditor list and other documents required at the time of filing; and for pre-petition review, analysis and advice to meet counsel's legal and ethical duties. Counsel's fees under this agreement were $____, of which [the] Debtor(s) paid $_____ and the balance (if any) was waived by counsel.
>
> b. The second, post-petition agreement provided for work to be performed after the filing, including all required tasks to complete the chapter 7 engagement. Counsel's fees under this agreement are $_____, which [the] Debtor(s) may pay in installments for up to _____ months after filing.

Where counsel utilizes a financing arrangement, the following might be added:

> Counsel has a recourse line of credit from a third-party lender secured by a collateral assignment of accounts receivable, including from [the] Debtor(s). Counsel's repayment obligation is not contingent upon payment by [the] Debtor(s).

If the financing involves a draw structure tied to an individual case, the following might be added:

> Counsel may draw upon the line of credit based upon the value of accounts receivable, including the amount owed by [the] Debtor(s).

If the lender also provides payment-management services:

> Lender provides payment-management and processing services and will collect installment payments from [the] Debtor(s) on behalf of counsel and apply amounts paid against counsel's indebtedness.

Finally, counsel should reassure the court that the debtor has been advised of and consented to this relationship in the following manner:

> Counsel has obtained informed consent from [the] Debtor(s) to the arrangement described above and to sharing limited information with lender concerning [the] Debtor(s) to facilitate the financing, payment-management and processing services.

13 11 U.S.C. § 504(a).
14 *See, e.g., In re Johnson*, 411 B.R. 296, 299 (Bankr. E.D. La. 2008).
15 Fed. R. Bankr. P. 2016(b).
16 Model R. Prof'l Conduct R. 5.4(a).
17 Litigation Funders' Contingent Interest in Legal Fees, Formal Opinion 2018-5 at 4 (New York Cy. Bar Assoc. July 30, 2018).
18 *Id.*
19 *Id.* at 5.

Conclusion

As the bifurcation and financing of chapter 7 attorneys' fees becomes more prevalent, attorneys should be vigilant in providing complete and accurate disclosure of these practices. Because Form B2030 is a Director's Form, it should be modified to assist counsel in fulfilling these disclosure duties. With appropriate care, counsel who bifurcate chapter 7 attorneys' fees and utilize financing arrangements to offer clients post-petition payment options can avoid any legitimate challenge to their disclosures. abi

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