AMERICAN BANKRUPTCY INSTITUTE

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Consumer

Consumer Ethics: Navigating the Tightrope

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Hon. Bruce A. Harwood
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CONCURRENT SESSION

2018

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Panelists:

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1. Internet Firms.

As consumer filings slow, seemingly more and more consumer practitioners are being lured into "partnering" as local counsel for internet firms as a way to increase revenue. However, not all that glitters is gold, as these cases illustrate:

a. *Robbins v. Delafield (In re Williams)*, 2017 Bankr. LEXIS 4183 (Bankr. W.D. Va. Dec. 8, 2017).

b. *In re Banks*, 2018 Bankr. LEXIS 315 (Bankr. W.D. La. Feb. 2, 2018).

c. *In re Foster*, 586 B.R. 62 (Bankr. W.D. Wash. 2018).

d. *In re Banner*, 2016 Bankr. LEXIS 2214, 2016 WL 3261886 (explanation of violation of ethics rules by internet & local counsel).

e. *In re Futreal*, 2016 Bankr. LEXIS 3974, 2016 WL 2609644 (local lawyer at least tried to do it right, but still ended up in trouble).

f. *In re Hanawahine*, 577 B.R. 573 (Bankr. D. Haw. 2017). This is an internet law firm case, where the chapter 7 debtor client was ill-advised by the national firm located online and the local lawyer who started representing her, then ceased when he had a falling-out with the national firm. The national firm and local lawyer were ordered to pay treble damages as a civil penalty under Code § 526, with the underlying damages consisting of the debtor's wages that were garnished when her bankruptcy case was not timely filed, as promised.

g. *In re Elrod*, 2017 Bankr. LEXIS 3911 (Bankr. E.D. Tenn. Nov. 14, 2017). A national internet firm attorney's motion to dismiss a complaint alleging unauthorized practice of law and negligence per se was denied, where a Tennessee debtor was incompetently advised to file a chapter 13 case instead of using the minimal funds needed to reinstate his mortgage debt by a lawyer not admitted in that state, then his bankruptcy case was mishandled by the designated local attorney.

2. Non-Traditional Fee Arrangements.

Traditionally, a consumer debtor's attorney is engaged via a plenary flat fee agreement, where all fees are paid in full prior to case filing. This is necessitated by the fact that obligations owing under a prepetition fee agreement are subject to the automatic stay and the bankruptcy discharge. *See Bethea v. Robert J. Adams & Associates*, 352 F.3d 1125 (7th Cir. 2003)(Three

debtors in bankruptcy hired lawyers before filing their petitions. Each agreed to a retainer that would cover the legal services entailed in preparing and prosecuting the proceedings. Unlike most retainers, however, these were to be paid over time--some installments before the petition was filed, others thereafter. The lawyers performed as promised: all three debtors received their discharges, and the cases were closed. When the lawyers continued to collect the unpaid installments, the three debtors (with the assistance of new counsel) commenced adversary proceedings in which they asked the bankruptcy court to hold their former lawyers in contempt for violating the injunctions implementing the discharges. Bankruptcy Court and District Court held that fees charged were reasonable and therefore not subject to discharge. The Seventh Circuit overruled lower courts finding that: 1) attorneys fees are not among the debts excepted from discharge by § 523; and 2) rejecting the lower court's reasoning that if attorneys fees are dischargeable § 329(b) would be rendered superfluous – 7th Circuit enumerates many uses for § 329(b) even if attorneys fees are subject to discharge.)

However, in light of the increasing costs post-BAPCPA[1] and the fact that pro se filers are burdensome to the whole system and are much less successful[2] has created a pressing need for an alternative to the traditional plenary flat fee agreement (enter Limited Services Agreements and Bifurcation).

a. Limited Services Agreements / Bifurcation

In spite of the concerns that unbundling raises, the ABA amended Model Rule 1.2(c) in 2002 to expressly allow limited-scope representation and provide a mechanism to regulate it. The ABA's goal was to "encourage attorneys to provide some assistance to low- and moderate-income litigants who could not otherwise afford full representation."

Rule 1.2(c) "[a] lawyer may limit the scope of representation if the limitation is reasonable under the circumstances and the client gives informed consent." Such limitations may be appropriate because the client has limited objectives for the representation, or may exclude specific means that might otherwise be used to accomplish the client's objectives. Such

[1] *See* Lois R. Lupica, The Consumer Bankruptcy Fee Study: Final Report, 20 AM. BANKR. INST. L. REV. 17 (2012)(For no-asset cases filed under Chapter 7, mean attorney fees have increased 48%—as high as $1,500 at the mean in some jurisdictions.).

[2] *See* Lois R. Lupica and Nancy B. Rapoport, Am. Bankr. Inst., Final Report of the ABI National Ethics Task Force (April 21, 2013).

limitations may exclude actions that the client thinks are too costly or that the lawyer regards as repugnant or imprudent.

The decision to unbundle must be specific to the particular circumstances of the client, the legal problem, and the court. The attorney has a duty to alert the client to legal problems which are reasonably apparent, even though they fall outside the scope of retention, and to inform the client that the limitations on the representation create the possible need to obtain additional advice, including advice on issues collateral to representation, i.e. the attorney still has duty to provide competent representation under Rule 1.1.

Rule 1.1: "A lawyer shall provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation." The duty of competence both informs and survives any and all limitations on the scope of services. The baseline obligation to inquire into the facts and circumstances of a case and analyze the possible legal issues is not changed when the scope of services is limited.

What does this all mean? An agreement to unbundle and limit services constitutes a breach of the duty of competence if the agreement excludes the services reasonably necessary to achieve the client's reasonable objectives. Debtors often come in with unreasonable or unachievable goals. The attorney's job is to determine how bankruptcy may help the debtor and whether some of the debtor's goals may be left unmet and effectively communicate this to the debtor.

i. *Tedocco v. DeLuca (In re Seare)*, 515 B.R. 599 (B.A.P. 9th Cir. 2014). These facts present the legal issue of when consumer bankruptcy attorneys such as DeLuca may limit the scope of their representation, a practice colloquially referred to as "unbundling." While unbundling is permissible, it must be done consistent with the rules of ethics and professional responsibility binding on all attorneys. Those rules allow a lawyer to limit his or her representation only when it is reasonable under the circumstances to do so, and only when the client gives informed consent to the limitation. In this case, DeLuca met neither of these requirements. As a defense, DeLuca asserts that his retainer overrides such mandatory rules. As will be seen, his position is incorrect; to the extent his retainer is inconsistent with the applicable rules of professional responsibility, his

retainer is unenforceable, and his abandonment of his clients violated norms applicable to lawyers generally.

ii. *In re Johnson*, 291 B.R. 462 (Bankr. D. Minn. 2003)(local rule requires counsel to perform all services except adversary proceedings without added fees; counsel cannot refuse to appear for § 341 meeting – even if debtors agreed to this for lower fee).

iii. *In re Egwim*, 291 B.R. 559 (Bankr. N.D. Ga. 2003)(counsel not allowed to limit scope of work, even as to adversary proceedings nd even with state RCP that allowed such limitations; withdrawal for failure to pay added fees allowed only if representation would be unreasonable burden on counsel).

iv. *In re Slabbinck*, 482 B.R. 576 (Bankr. E.D. Mich. 2012)

v. *In re Grimmett*, 2017 Bankr. LEXIS 1492, 2017 WL 2437231 (Bankr. D. Idaho June 5, 2017). The chapter 7 debtor's law firm undertook such efforts to ensure it was paid in full that it potentially impaired its client's ability to obtain effective relief through the bankruptcy filing and violated bankruptcy laws and ethical rules. A fee agreement was signed after the debtor a month before the bare-bones petition filing, accompanied by a request to pay the filing fee in installments (promptly granted) and payment of $500 prepetition to the lawyer. The engagement agreement included a form allowing the lawyer to draft funds from the debtor's debit card without further notice or consent, and provided that the debtor consented to a billing company to collect fees from the debtor pursuant to a factoring loan agreement. The lawyer threatened the client with dire consequences of nonpayment when she fell behind in installments, and the U.S. Trustee sought disgorgement of all fees. The lawyer claimed his collection tactics were not abusive and that his fee agreement was permissible under *In re Hines*, 147 F.3d 1185 (9th Cir. 1998).

The court found that the engagement agreement committed the lawyer to perform almost all of the services the debtor needed to obtain effective bankruptcy relief, but it also granted counsel the contractual right

to withdraw if she failed to pay. The court questioned whether the particular unbundling agreement was reasonable and whether the client gave truly informed consent as required by applicable ethics regulations, but ruled the agreement impermissible just as a matter of bankruptcy law. The agreement was held improper because lawyer was not obligated to perform critical services such as appearing at the 341 meeting if the client failed to pay, and certain services such as helping with reaffirmation agreements and stay relief motions would be separately billed. And because the entire agreement was executed prepetition, the debtor's payment obligation was discharged and he could only seek fees for postpetition work on quantum meruit grounds.

Further, the lawyer likely violated the automatic stay by his collection efforts. He had a conflict of interest in collecting without informing the client of the discharged fees and implying that he could withdraw without advising that the court would have to approve it. The court therefore deemed compensation excessive under § 329(b), and also found that Rule 2014 disclosures were inaccurate, both grounds for denial of compensation. The lawyer's payment coercion efforts also violated the installment fee order, which requires full payment of the filing fee before any further payments are made to counsel. And he used computer software for client signatures instead of obtaining wet signatures, another ground for fee disgorgement.

b. Chapter 13 as solution for need for non-traditional fee arrangement?

In Chapter 13 attorney's fees may be paid over time post-petition, which, increasingly, is making Chapter 13 an alternative for debtors who would otherwise qualify, but cannot afford a traditional plenary flat fee Chapter 7.

i. *Ulrich v. Schian Walker, P.L.C. (In re Boates)*, 551 B.R. 428 (B.A.P. 9th Cir. 2016)(rehearing denied by *Ulrich v. Schian Walker, P.L.C. (In re Boates)*, 554 B.R. 472 (B.A.P. 9th Cir. 2016)).

ii. SD Ala. Local General Order No. 19.

iii. *Brown v. Gore (In re Brown)*, 742 F.3d 1309 (11th Cir. 2014)(circuit case on filing 13 when 7 is better for the client but 13 is better for the attorney)

iv. *In re Pursley*, 2017 WL 4480235 (Bankr. E.D.Tenn. Oct. 6, 2017). The chapter 13 trustee objected to the debtor's attorney's fee of $3,250 (under the "no look" $3,750 because of no secured creditors) as excessive because it would represent 51.58% of the total plan payments of $6,300, providing unsecured creditors with a 30% dividend. The chapter 13 trustee wanted the fee reduced to $2,000, bringing the unsecured creditors' dividend to 44%. The debtor was entitled to a chapter 7 discharge, and the standard chapter 7 fee for the debtor's counsel in such a case would have been $1,750. The court discussed how a chapter 13 could be more beneficial to the debtor's attorney than to the debtor and said counsel should be prepared to explain what benefits the longer and more expensive chapter 13 provides to the client – which could be non-economic, such as the debtor's wish to protect a family member who cosigned a note. The court presented a thorough analysis of the facts in the case and overruled the objections on those facts.

v. *In re Nielsen*, 2017 2017 WL 57260 (D. Colo. Jan. 4, 2017). The district court upheld bankruptcy court sanctions including attorneys' fees and punitive damages under 11 U.S.C. § 362(k) against the lawyers who filed the most consumer cases in that district. They marketed and used a "zero down" bankruptcy filing program where a client could hire the firm without paying any up-front fees. Instead, a client would sign an agreement to make payments through regular automatic bank or debit card withdrawals in a total amount the bankruptcy court said was significantly higher than the going rate in that district, $2,500 for a chapter 7 case. The client was required to sign a promissory note for the full fee and begin making payments at or soon after the initial consultation. The client was advised that nonpayment would result in a collection action. And the client also signed an agreement to reaffirm the debt after the petition was filed. It informed the client that reaffirmation was voluntary but also explained

that lawyers were only willing to provide post-petition services provided that the client reaffirmed the debt. Bankruptcy courts began denying the reaffirmations, but the law firm kept deducting fees from bank accounts. After lengthy proceedings, the bankruptcy court found intentional stay violations. It determined minimal actual damages, awarded $2,000 punitive damages, but declined to award all fees billed by the debtors' replacement counsel who litigated against the firm because they excessively billed on a crusade to shut down their competitor and duplicated work of the U.S. Trustee. The district court affirmed, and the state supreme court suspended the lawyers' licenses.

vi. Which lead to a practice called "Fee Jumping". *See In re Gilliam*, 582 B.R. 459 (Bankr. N.D. Ill. 2018).

3. Coverage counsel / appearance counsel are now also used increasingly by debtor's and creditor's attorneys alike.
4. Trustee misbehavior
    a. *In re Bird*, 577 B.R. 365 (10th Cir. BAP 2017). In the context of determining that the fees incurred by a chapter 7 trustee and his counsel (his own law firm) were unreasonable, the BAP addressed the trustee's duties to the estate and debtor, and competing policies of a debtor's fresh start and payment of unsecured creditors. The debtors' homesteads were subject to liens exceeding their value. But rather than abandoning the property, the trustee entered into stipulations with lienholder the IRS to carve out $10,000 from the proceeds of any sale otherwise payable to it, and moved to sell the property for only a small amount more than the liens. The sale proceeds would be subject to the trustee's and his counsel's fees and broker and closing costs. Effectively, the sale would eliminate the debtors' homesteads, leave them with nondischargeable tax claims, and transfer funds to the trustee and his counsel for unnecessary fees without a meaningful distribution to unsecured creditors.

    The proposed sale was circumvented by conversion to chapter 13, but the trustee and his counsel sought a fee award for their efforts, which the bankruptcy court denied. The BAP noted the trustee's fiduciary duties to the

estate, and that the duty to liquidate assets for creditor distributions is limited. When liquidation would result in little to no payment to unsecured creditors, the proper course of action is to abandon the property. It held the bankruptcy court did not err in concluding the services rendered were not reasonably likely to benefit the estates, or in denying the fee applications in their entirety.

5. Creditor Misbehavior.
    a. *Castellanos Grp. Law Firm, L.L.C. v. FDIC (MJS Las Croabas Props.)*, 545 B.R. 401 (B.A.P. 1st Cir. 2016)(creditor's lawyer sanctioned for failing to respond to efforts to resolve dispute and gave up on morning of the hearing, causing needless cost to the court and opposing counsel)
    b. *Grossman v. Wehrle (In re Royal Manor Mgmt.)*, 652 F. App'x 330 (6th Cir. 2016)(6th Cir. 2016) affirming 525 BR 338 (6th Cir BAP 2015) (creditor's counsel sanctioned for pursuing claims premised on meritless arguments that delayed distributions to legitimate claimants and eroded funds)
    c. *In re Martinez*, 393 B.R. 27 (Bankr. D. Nev. 2008)(bank's counsel sanctioned for refusing to stipulate to correction of a mistake, on the client's direction)
6. Due Diligence / Disclosure / Illegal client conduct during a bankruptcy case
    a. *Richardson v. Swisher (In re Swisher)*, 2017 Bankr. LEXIS 4028 (Bankr. C.D. Ill. Nov. 22, 2017).
    b. *Dignity Health v. Seare (In re Seare)*, 493 B.R. 158 (Bankr. D. Nev. 2013).
    c. *In re Griffin*, 563 B.R. 171 (Bankr. M.D.N.C. 2017). The court entered a show cause order for why the debtor's attorney should not be sanctioned for violating Rule 9011 by filing a declaration in connection with a reaffirmation agreement with inaccurate facts and without personal knowledge of its content. The opinion discusses the critical role of attorneys with respect to reaffirmation agreements, including exercising independent judgment in determining whether the agreement imposes an undue hardship, verifying the creditor's security interests and confirming that liens are unavoidable, as well as advising the debtor of other available options.