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Discussion of Selected Commission Student Loan Recommendations

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This paper addresses certain recommendations made by the ABI Commission on Consumer Bankruptcy (the "Commission") in connection with the Final Report of the Commission. Am. Bankr. Inst., *Final Report of the ABI Commission on Consumer Bankruptcy* 1-13, Robert M. Lawless (2019) (the "Report").

I. Background

The topic of discharge and dischargeability of student loans debt and the topic of the distribution priority of unsecured student loan debt claims are front and center in the Report. The Report recognizes student loan defaults as "one of the most significant economic problems facing the United States." *Report*, p. 2. The Report indicates that student loan debt has tripled since 2006, from under $500 billion to over $1.5 trillion today. Citing recent evidence, the Report states that student loan debt greatly exceeds both auto loan and credit card debt and that student loans have the highest delinquency rate of any consumer debt. The Report details the societal impact of student loan delinquency, including lower earnings, lower levels of homeownership, lower automobile purchases, rampant household financial distress, a lower probability of students choosing public service careers, poorer psychological functioning, delayed marriage and lower probability of continuing education through graduate school.

The Report provides a fulsome history of student loan dischargeability policies and case law, including the evisceration of the so-called "seven-year rule," the facts of the *Brunner*[1] case and its development as a test for determining whether "excepting [a student loan] debt from discharge…would impose an undue hardship on the debtor and the debtor's dependents…" 11 U.S.C. § 523(a)(8). The Report also details the inclusion of private student loans in the list of non-dischargeable debt set forth in section 523(a)(8) of title 11 of the United States Code (the "Bankruptcy Code").

The Commission sets forth a discussion of the policy considerations behind the exception to discharge for student loan debt, including (1) the idea that student loans enable increased earning power, which can be used to repay loans (as well as the idea that discharging student loan debt would discourage students from using their education to maximize their earning and repayment potential), (2) the suggestion that allowing non-payment of a debt that enabled a higher income is unfair, and (3) the point that the government student loan program is built upon the concept that

[1] Brunner v. New York State Higher Educ. Serv. Corp. (*In re Brunner)*, 46 B.R. 752 (S.D.N.Y. 1985), *aff'd* 831 F.2d 395 (2d Cir. 1987).

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students must repay their loans to sustain the program so that the funds can be borrowed by future students.[2]

Lastly, the Commission recognized the challenges faced by debtors in chapter 13 with substantial non-dischargeable student loans. Current law limits a debtor's ability to separately classify student loan debt in a chapter 13 plan. Without separately classifying student loan debt and paying student loan debt with interest, many chapter 13 debtors will emerge with substantial balances that can lead to future financial distress.

In balancing the existing student loan crisis and the policies underpinning the student loan system, the Commission made three types of recommendations – those requiring Congressional action, those requiring changes in regulations by the United States Department of Education and suggestions for best interpretations of the current case law (what some might view as recommendations for judicial action). Set forth below are some recommendations in two of the categories and some discussion points on each.

II. Statutory Amendments.

A. Return to the Seven-Year Rule.

1. Commission Recommendation. The Commission recommends that Congress amend section 523(a)(8) to restore the "seven-year rule" under which student loans may be discharged without a finding of undue hardship after seven years from the time they first became payable. The Commission's rationale is that "[i]f a debtor cannot obtain sufficiently lucrative employment to repay a student loan that has long been outstanding, it is unlikely that the debtor's circumstances will change to allow significant repayment of the student loan." *Report*, p. 6.

The Commission recognized that BAPCPA's elimination of the seven-year rule was "[t]he most significant development for the treatment of student loans in bankruptcy." *Report* at 5. It observed that "[t]he rule now became that student loans were nondischargeable at any time unless the debtor made a showing of undue hardship." *Id.*

It is worth noting that in the text of the recommended Bankruptcy Code changes,[3] the Commission specifically states that a loan should be dischargeable if it has been outstanding for seven years "regardless of any suspension of payments." *Report* at p. 1. This is an important distinction from prior law, which deducted from the time loans were in repayment "any applicable suspension of the repayment period." 11 U.S.C.A. (West) § 523(a)(8)(A) (effective until April 25, 1996).

A 1996 bankruptcy case from the Southern District of Ohio is instructive regarding the policy behind excluding suspensions in repayment. In that case, the issue was whether the period during which the automatic stay was in effect was an "applicable suspension of the repayment

[2] Though not mentioned in the Report, student loan lenders might add that it is illegal discriminate against student loan borrowers based on credit-worthiness, making it a significant social program and distinguishing student loan debt from other debt.

[3] There is no discussion of this point in the text of the Report.

period" under former section 523(a)(8)(A). In that case, the court noted that "Congress expressed its concern that student loans should not be dischargeable without some effort on the debtor's part to repay the loan." *In re Moody*, 202 B.R. 720 (Bankr. S.D. Ohio 1996) (internal citations and quotations omitted). The court cited the following from the Senate Bill enacting section 523(a)(8).[4]

> The Committee bill seeks to eliminate the defense of bankruptcy for a five-year period, to avoid the situation where a student, upon graduation, files for a discharge of his loan obligation in bankruptcy, then enters upon his working career free of the debt he rightfully owes. After a five-year period, an individual who has been faithfully repaying his loan may really become bankrupt. He should not be denied this right, and is not under the Committee bill.

S.Rep. No. 882, 94th Cong., 2d Sess. 32 (1976), reprinted in 1976 U.S.C.C.A.N. 4713, 4744. And in the original version of section 523(a)(8)(A), there was no deduction of the period within which loans were in suspension.

But in 1979, Congress added the reference to the suspension of the repayment period. According to the Senate Bill, "Section 3(2) of the bill would also amend 11 U.S.C. 523(a)(8) to exclude periods of deferment from the calculation of the first five years of the repayment period." S.Rep. No. 230, 96th Cong., 1st Sess. 2 (1979), reprinted in 1979 U.S.C.C.A.N. 936, 937 (emphasis added). As one court put it,

> Here Congress shows its concern that a debtor should not be able to manipulate deferments in order to defeat the five-year period required before a student loan could be discharged. Noting that student loans are subject to deferment, the committee acted to remove time under a deferment from the calculation of the five-year period before a student loan could be discharged.

Williams v. U.S. Dept. of Educ. *(In re Williams)*, 195 B.R. 644, 646–647 (Bankr.N.D.Tex.1996).

2. Discussion Point. Would the Commission's recommendation to eliminate the "suspensions of payment" language make it easier to adjudicate a seven-year claim? Is this something that Congress would likely adopt given the policy concerns it expressed in 1979?

B. Statutory Amendments – Priority for Student Loan Debt and Treatment in Chapter 13.

Two of the Commission's proposed amendments to the Bankruptcy Code would be helpful to both debtors and student loan creditors, and the Report states that they are intended to facilitate more efficient repayment on federally backed student loans. These proposed changes may mitigate

[4] When first enacted, the "Seven-Year Rule" was a "Five-Year Rule" and required loans to have been in repayment for only five years.

some, but not all, of the effect of other aspects of the Report on student loan creditors, those that would make student loans significantly more likely to be discharged under section 523(a)(8).

These proposed amendments are:

(2) Section 507(a) should have a new, eleventh priority for claims excepted from discharge under section 523(a)(8).

(3) Section 1322(a) should allow the plan to provide for less than full payment of all amounts owed for a claim entitled to the student loan priority only if the plan provides that all of the debtor's projected disposable income for a five-year period beginning on the date that the first payment is due under the plan will be applied to make payments under the plan.

1. Priority for Student Loan Debt

Currently, student loans are treated as general nonpriority unsecured claims, though the Bankruptcy Code treats the debt evidenced by such claims as nondischargeable short of a section 523(a)(8) undue hardship discharge in an adversary proceeding. With a few exceptions, most priority unsecured claims are generally nondischargeable, while most general unsecured claims are dischargeable. The Commission proposes to make nondischargeable student loan debt a priority unsecured claim and put it last in line under the current priority scheme.

The Commission briefly touches on how its proposed change would affect chapter 7 distribution. Simply, it would move the payoff of the student loan claim ahead of general unsecured claims, resulting in a greater distribution from the bankruptcy estate. This change would have the practical effect of shifting distribution away from general unsecured creditors, and in favor the student loan creditors who hold nondischargeable debt.

The change would also benefit the debtor because the debtor would be able to satisfy more nondischargeable debt through trustee distributions. Currently, in an ordinary chapter 7, student loan creditors share *pro rata* in the distribution with other general unsecured creditors, and the balance of the student loan debt would remain after the discharge because it is nondischargeable. If distribution is shifted to the student loan claims from the general unsecured claims (which are generally dischargeable), the practical effect will be the satisfaction of more claims evidencing nondischargeable debt, and thus, the carry forward of less nondischargeable debt, which will reduce the debtor's post-discharge liability. The Commission does not note this change in the chapter 7 context, though it does mention it briefly in the chapter 13 context: "Carrying through that priority into the chapter 13 plan not only furthers the policy goal of repayment of federally backed student loans but also helps further the debtor's fresh start by reducing the amount of nondischargeable debt that will remain after the chapter 13 case ends." *Report*, p. 8.

The ultimate satisfaction of more nondischargeable debt by the proposed change in the priority scheme affects chapter 7 and chapter 13 cases, but as the Commission notes, many chapter 13 plans already call for special treatment of student loan debt. *Id.* Though a chapter 13 plan may organize unsecured claims into classes, it may not unfairly discriminate against any one class

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pursuant to section 1322(a)(2). *Id.* There is a split of authority on the extent to which student loan debt can be separately treated (*i.e.,* favored) in a chapter 13 plan before it rises to the level of unfair discrimination. *Id.* There is no dispute, however, that a chapter 13 plan may treat priority unsecured debt separately, so the Commission's proposed change would resolve that disagreement. *Id.* Student loan creditors would receive more repayment under a chapter 13 plan by the proposed amendment, but this proposed amendment, like any proposed change to priority claims, would necessarily result in general unsecured creditors receiving less.

2. Excepting Student Loan Debt from Payment in Full in Chapter 13

If the previously discussed change is implemented, the Commission proposes a corollary amendment that would except student loans from the "full payment" requirement of section 1322(a)(2), that applies to most other priority unsecured debt. Section 1322(a)(2) requires that any priority debt be paid in full by a chapter 13 plan, unless the creditor holding the debt agrees otherwise. The proposed change to section 1322(a)(4) would allow a debtor to not fully pay off a student loan creditor in a chapter 13 plan, as long as that debtor is devoting every cent of disposable income to the chapter 13 plan over five years.

Student loan debt is often quite high, and this change would prevent a student loan creditor from having a constructive veto over a chapter 13 plan if its debt were not to be paid in full. As a practical matter, however, student loan creditors are likely to support plans where they paid as much as the debtor is able, ahead of all general unsecured claims. In any case where the student loan debt exceeds the debtor's ability to pay it in full through a chapter 13 plan, that plan would then give a 0% distribution plan to general unsecured creditors. The combination of these two changes could shift a significant amount of estate distributions to student loan creditors that would otherwise be paid to general unsecured creditors.

3. Discussion Points

a. Many of the Commission's other recommendations make it easier to discharge student loan debt, on one hand, but this recommendation also moves nondischargeable student loan debt into higher priority, on the other. Is there policy-based tension between those two changes? Practical tension?

b. General unsecured creditors would bear the greatest cost of the proposed changes to the priority scheme as to nondischargeable student loan debt, and will not benefit by the corresponding change of making student loans easier to discharge. This is because general unsecured creditors would still split estate distributions *pro rata* with nonpriority dischargeable student loan debt, as they do now. Will this change the way a potential creditor may underwrite and be willing to make an unsecured loan to a borrower with high student loan balances? Could high student loan balances result in lower credit scores given the increased risk to general unsecured creditors? There are certainly many chapter 13 cases with 100% plans, but there are also many cases with 1% plans, where this point might be moot.

III. The Commission's Proposed Best Interpretation of the *Brunner* Test

A. The *Brunner* Test

The Commission cites the test from *Brunner v. New York State Higher Educ. Serv. Corp. (In re Brunner)*, 46 B.R. 752 (S.D.N.Y. 1985), aff'd, 831 F.2d 395 (2d Cir. 1987) (the "*Brunner* test") as the widely accepted test to determine whether a debtor qualifies for an undue hardship discharge of student loan debt under section 523(a) repaying student loans:

> (1) the debtor cannot maintain, based on current income and expenses, a minimal standard of living for herself and her dependents if forced to repay the loans;
>
> (2) additional circumstances exist indicating that this state of affairs is likely to persist for a significant portion of the repayment period of the student loans; and
>
> (3) the debtor has made good faith efforts to repay the loans.

B. The Commission's Proposed Test

The Commission recommends the following best interpretation of *Brunner* (the "Proposed Test"):

> The three-factor Brunner test should be understood to require the debtor to establish only that:
>
> (1) the debtor cannot pay the student loan sought to be discharged according to its standard ten-year contractual schedule while maintaining a reasonable standard of living,
>
> (2) the debtor will not be able to pay the loan in full within its initial contractual payment period (ten years is the standard repayment period) during the balance of the contractual term, while maintaining a reasonable standard of living, and
>
> (3) the debtor has not acted in bad faith in failing to pay the loan prior to the bankruptcy filing.

C. State of Circuit Law Regarding the *Brunner* Test

A selection of cases from various circuits throughout the country is set forth below, illustrating the distance between the Proposed Test and the current interpretation of the *Brunner* test in each circuit – if the circuit in question uses the *Brunner* test at all. The circuits are roughly grouped according to the similarity of their interpretations.

The cases discussed are not intended to present a comprehensive review of all nuances of section 523(a)(8) law across the circuits, but rather a snapshot into some recent prevailing trends, in light of the Proposed Test. We also offer some light analysis of how far the state of the case law in any circuit may be to the Proposed Test.

1. The Second Circuit – Grappling with *Brunner* and the Commission's Proposed Test

The Second Circuit

The *Brunner* test originated within the Second Circuit, but its customary application is currently being questioned from bankruptcy courts within that circuit itself. The three cases discussed below each cite the Commission's Report directly. Two approvingly as persuasive authority, and one with more skepticism, questioning whether it can adopt the Proposed Test without actual legislative change.

Chief Judge Morris of the U.S. Bankruptcy Court for the Southern District of New York recently wrote that the current predominate application of the *Brunner* test is the result of "retributive dicta [that was] applied and reapplied so frequently in the context of *Brunner* that they have subsumed the actual language of the *Brunner* test. They have become a quasi-standard of mythic proportions so much so that most people (bankruptcy professionals as well as lay individuals) believe it impossible to discharge student loans." *In re Rosenberg*, 610 B.R. 454, 459 (Bankr. S.D.N.Y. 2020), leave to appeal granted sub nom, *Rosenberg v. Educ. Credit Mgmt. Corp.*, 2020 WL 1048599 (S.D.N.Y. Mar. 4, 2020). The *Rosenberg* decision, which remains on appeal, cites the Commission's Report directly as persuasive authority for the point that a court should consider a ten-year repayment period terms of loan itself, and not alternatives offered by the creditor such as an income-based repayment plan. *Id*. In response, a student loan guarantor might argue that because income-based repayment plans are offered based on statutory regulations, they should be considered as an element of the loan terms themselves.

One month after the *Rosenberg* opinion, another judge in the same district made clarifications to the interpretation of the *Brunner* test, based on *Rosenberg*. That judge wrote that to satisfy the second prong of the *Brunner* test, it is unnecessary to demonstrate a "certainty of hopelessness," a requirement that some courts still impose. *In re Clavell*, 611 B.R. 504 (Bankr. S.D.N.Y. 2020). Further, that a showing of undue hardship does not require exceptional circumstances, but rather only circumstances that show a debtor's inability to pay will last for a significant portion of the loan repayment period. Finally, that a showing of good faith only requires that "the debtor may not willfully or negligently cause his own default, but rather his condition must result from factors beyond his reasonable control." *Id.*

Although these New York bankruptcy courts' recent interpretations would maintain the traditional language of the *Brunner* test, it would bring that interpretation closer to the Proposed Test. The *Clavell* decision approvingly cites the Commission's recommendations: "There have been many proposals to modify section 523(a)(8) and/or to modify the Brunner factors. See, e.g., Am. Bankr. Inst., *Final Report of the ABI Commission on Consumer Bankruptcy* 1-13 (2019)." *Id.*

For example, although the *Clavell* case keeps the need for an affirmative showing of good faith, its interpretation of that prong of the *Brunner* test would, as a practical matter, bring it closer to defense against a bad faith showing considered by the Proposed Test.

Several months before *Rosenberg* and *Clavell*, however, another bankruptcy judge in New York, this time in the Northern District, cited and rejected the Commission's Proposed Test:

> Some courts and commentators have questioned the continued application of Brunner. [Footnote: … ABI Commission on Consumer Bankruptcy, Final Report of the ABI Commission on Consumer Bankruptcy 2017-2019 Final Report and Recommendations p, 11-13 Robert M. Lawless (2019) (recommending inter alia that courts deny discharge only where a debtor has actually acted in bad faith).] The Second Circuit, however, continues to follow Brunner and has declined to revisit it. Absent Congressional legislation that changes the standard for discharging student loans, Brunner remains binding precedent which this court must apply. Debtor must prove each Brunner prong by a preponderance of the evidence for the court to discharge his student loans.

In re Shenk, 603 B.R. 671, 676 (Bankr. N.D.N.Y. 2019). In doing so, this bankruptcy court in the Second Circuit also upheld the existing interpretation of *Brunner* that requires an affirmative showing of good faith. *See id.* at 681. The *Shenk* case articulates the practical difficulties of overcoming precedent which may slow or outright frustrate the widespread adoption of the Proposed Test, as recommended by the Commission.

2. The First and Eighth Circuits – Rejecting *Brunner* for "Totality of the Circumstances"

The First Circuit

The First Circuit BAP recently affirmed a bankruptcy court's rejection of the *Brunner* test altogether, and instead used a totality of the circumstances test. *See In re Schatz*, 602 B.R. 411, 417 (B.A.P. 1st Cir. 2019); *see also In re Erkson*, 582 B.R. 542, 550 (Bankr. D. Me. 2018).

The totality of the circumstances test as applied in the First Circuit is that a debtor must prove, by a preponderance of the evidence, that the following factors prevent her from paying the student loans in question while still maintaining a minimal standard of living: (1) her past, present, and reasonably reliable future financial resources; (2) her and her dependents' reasonably necessary living expenses; and (3) other relevant facts or circumstances unique to the case. *Erkson*, 582 B.R. at 549 (internal formatting omitted) *quoting In re Bronsdon*, 435 B.R. 791 (B.A.P. 1st Cir. 2010).

While the Proposed Test is framed by the Commission as a best interpretation of the *Brunner* test, the First Circuit's totality test is actually more similar to the factors set forth in the Proposed Test in some ways than the way the *Brunner* test is presently applied by some other courts. For example, in *Erkson*, like in the Proposed Test, the court stated that the debtor only had to defend against a showing that she acted in bad faith when attempting to repay the loans, not the

prevailing *Brunner* element of having to prove affirmatively that she acted in good faith. *Id.* at 550-51.

The Eighth Circuit

The Eighth Circuit, like the First Circuit, has rejected the *Brunner* test outright, in favor of a totality of the circumstances test. The Eighth Circuit BAP's most recent recitation of the elements is similar, but not identical to, the First Circuit's: "This test establishes three areas of inquiry: "(1) the debtor's past, present, and reasonably reliable future financial resources; (2) a calculation of the debtor's and [any] dependent's reasonable necessary living expenses; and (3) any other relevant facts and circumstances surrounding each particular bankruptcy case." *In re Piccinino*, 577 B.R. 560, 564 (B.A.P. 8th Cir. 2017).

As noted above when discussing the First Circuit, the Eighth Circuit's rejection of the *Brunner* test for a totality of the circumstances test may actually have a more similar practical impact to the Proposed Test than to other applications of the *Brunner* test itself.

The Eighth Circuit's test may still be less debtor-friendly than the Proposed Test, however, because the issue of whether debtors availed themselves of income-based repayment plans is still considered a factor in that circuit's analysis. *In re Swafford*, 604 B.R. 46, 52 (Bankr. N.D. Iowa 2019). Under the Proposed Test, it seems unlikely that income-based repayment options will play a factor, when debtors must only to show that they have not acted in bad faith.

3. The Seventh, Ninth, and Tenth Circuits – a Standard Formulation of the *Brunner* Test, but "Hopelessness" of Repayment Is Not Required for a Discharge

These circuits are further from the Proposed Test than recent trial court cases in the First, Second, and Eighth Circuits. As we will detail later, however, they appear to have softened their positions on a debtor's ability to discharge student loan debt relative to some of their sister circuits.

The Seventh Circuit

Some courts in the Seventh Circuit have explicitly backed off the "certainty of hopelessness" language as a fundamental element of proving student loan dischargeability under undue hardship. *In re Bukovics*, 2020 WL 949936, at *10 (Bankr. N.D. Ill. Feb. 25, 2020); *In re Davis*, 608 B.R. 693, 705 (Bankr. N.D. Ill. 2019). Both of those cases cite *Tetzlaff v. Educ. Credit Mgmt. Corp. (In re Tetzlaff)*, 794 F.3d 756, 759–60 (7th Cir. 2015) for that proposition.

Other courts in the Seventh Circuit, however, continue to require a "certainty of hopelessness" as an essential element of a student loan discharge claim. *See In re Echelbarger*, 600 B.R. 39, 47 (Bankr. S.D. Ind. 2019) ("Debtor must show there is a 'certainty of hopelessness' in that she will not be able to fulfill her commitment at any point." Even while acknowledging that "[m]ore recently, the Seventh Circuit has shown more compassion in analyzing this prong.")

Even intra-circuit, the case law application and interpretation of the *Brunner* test is not entirely clear or consistent.

The Ninth Circuit

The Ninth Circuit still uses a relatively standard formulation of the *Brunner* test, and has generally not cited the language concerning "certainty of hopelessness," and recent cases in this circuit, based on older precedent, have held that the additional circumstances to satisfy the second prong of the *Brunner* test need to be "exceptional." *In re Smith*, 608 B.R. 236, 241 (Bankr. D. Or. 2019); *see also In re Nys*, 446 F.3d 938 (9th Cir. 2006).

At least one recent case from the U.S. Bankruptcy Court for the District of Oregon explicitly rejects hopelessness as a requirement: "The debtor must make more than a showing of tight finances but is not required to prove utter hopelessness." *In re Nitcher*, 606 B.R. 67, 74 (Bankr. D. Or. 2019) (internal quotations omitted). The *Nichter* case cites a Ninth Circuit BAP case from 1999. *In re Nascimento*, 241 B.R. 440 (9th Cir. BAP 1999).

The Tenth Circuit

The Tenth Circuit uses the *Brunner* test, but has generally steered clear of any language requiring "hopelessness." *In re Regan*, 590 B.R. 567, 574 (Bankr. D.N.M. 2018) ("To meet the required standard, a debtor must show more than temporary financial adversity but need not demonstrate utter hopelessness.") The court recognized that the Tenth Circuit has instructed its lower courts that a distillation of the *Brunner* test should be that "the terms of the test must be applied such that debtors who truly cannot afford to repay their loans may have their loans discharged. *Id*. This language has been the standard in the Tenth Circuit since 2004. *Educ. Credit Mgmt. Corp. v. Polleys*, 356 F.3d 1302 (10th Cir. 2004).

In a recent case, a court in the Tenth Circuit found student loans predominately dischargeable even when the debtor spent money every month on gambling, cigarettes, and fast food, in part because at 59, it was impossible that she would ever fully repay her loans. *In re Metz*, 589 B.R. 750, 755 (Bankr. D. Kan. 2018), aff'd sub nom. *Educ. Credit Mgmt. Corp. v. Metz*, 2019 WL 1953119 (D. Kan. May 2, 2019). The *Metz* court discharged all but the debtor's original $16,613.73 original loan balance, where the discharged amount was several times the original balance.

The most recent appellate case in the Tenth Circuit is from the District of New Mexico, and it reaffirmed that hopelessness of repayment is not required in the Tenth Circuit for a discharge. *In re Nitka*, 2020 WL 4218823, at *9 (10th Cir. BAP (Colo.) July 23, 2020). The Tenth Circuit B.A.P., however, affirmed a ruling that the debtor's student loans were not dischargeable because the debtor was a relatively young man who had previously been gainfully employed, but was currently choosing to live at his mother's house without looking for new work. The *Nitka* debtor, therefore, failed the element of the *Brunner* test showing that the financial situation would persist for a significant portion of the repayment period.

4. <u>The Third and Fourth Circuits – Circuit Precedent Exists Requiring the Hopelessness in Repayment to Receive a Discharge, But Recent Cases May be Trending Away</u>

The Third and Fourth Circuits have older, pre-BAPCPA cases at the circuit level endorsing the "certainty of hopelessness" requirement for a debtor to receive a discharge, and those cases

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have not been overruled. In these circuits, however, recent opinions considering *Brunner* have not suggested that hopelessness is necessary – whether that is a coincidence or a trend remains to be seen.

The Third Circuit

A circuit level case from 2001, *In re Brightful*, 267 F.3d 324, 328 (3d Cir. 2001), cites language endorsing the idea that "dischargeability of student loans should be based upon the certainty of hopelessness." The two cases discussed here, however, do not mention the "certainty of hopelessness" language when discussing *Brunner*, or citing *Brightful*.

A case from the Middle District of Pennsylvania found that a debtor had not acted in good faith when he had not made loan payments, had not applied for income-based repayment options, and the student loans at issue were the substantial majority of debt the debtor sought to discharge. *In re DiFrancesco*, 607 B.R. 463, 468 (Bankr. M.D. Pa. 2019).

Again, distinct from the Proposed Test's third factor, which merely requires a debtor to have not acted in bad faith, the *DiFrancesco* opinion suggests that whether a debtor has applied for income-based repayment is an element of good faith.

The most recent trial court case in the Third Circuit comes from the Western District of Pennsylvania, where the bankruptcy court acknowledged that it was asked to disregard "certainty of hopelessness," and instead look to the *Rosenberg* decision as persuasive authority. *In re Rubash*, 2020 WL 2554234, at *6 (Bankr. W.D. Pa. May 19, 2020). The *Rubash* court, however, noted that it is controlled by the binding precedent of the Third Circuit, and declined to rule against that precedent. *Id.*

The Fourth Circuit

Like the Third Circuit, the Fourth Circuit has an older case, *In re Frushour*, 433 F.3d 393, 401 (4th Cir. 2005), where the "certainty of hopelessness" is discussed as a required element of the second prong of the *Brunner* test. And there are cases as recent as 2018 that still cite *Frushour* for this proposition. The last three bankruptcy court level opinions from this circuit, however, cite *Frushour* but do not discuss the "certainty of hopelessness." So, while *Frushour* remains precedential, it is possible that there is a trend emerging towards backing away from the requirement of a certainty of hopelessness to discharge a student loan debt, or it is possible that the next case will confirm the Fourth Circuit's commitment to requiring the "certainty of hopelessness" in its section 523(a)(8) analysis.

The U.S. Bankruptcy Court for the District of South Carolina found that pursuing an available administrative student loan discharge was not necessary for a debtor to receive a bankruptcy discharge in *In re Lagueux*, 604 B.R. 249, 251 (Bankr. D.S.C. 2019) – while citing *Frushour* and not the "certainty of hopelessness." See also *In re Halatek*, 592 B.R. 86 (Bankr. E.D.N.C. 2018) and *In re Menefee*, 2018 WL 4501119, at *3 (Bankr. E.D. Va. Sept. 18, 2018), two cases where bankruptcy courts in the Fourth Circuit denied debtors student loan discharges and cited *Frushour*, but did so without ever mentioning the "certainty of hopelessness" language.

The most recent case from the Fourth Circuit endorsing the "certainty of hopelessness" is from early 2018, and the U.S. Bankruptcy Court for the District of Maryland. *In re Augustin*, 588 B.R. 141 (Bankr. D. Md. 2018). This could indicate that the *Laguex*, *Halatek*, and *Menefee* bankruptcy courts simply did not find that their cases required mentioning that language, but just as likely, it could also mean that those courts intentionally omitted it.

5. The Fifth, Sixth, and Eleventh Circuits – An Interpretation of the *Brunner* Test Requiring the "Certainty of Hopelessness" to Receive a Discharge

The "certainty of hopelessness" requirement to proving undue hardship has been explicitly rejected by some of the previously discussed circuits as unnecessary to the application of the *Brunner* test, and would certainly not be mandatory under the Proposed Test, but as recently as late 2019, three circuits still suggest that a finding that repayment is certain to be hopeless as an essential element of receiving a discharge under the *Brunner* test.

The Fifth Circuit

A case in from the Southern District of Mississippi recently held that student loan repayment may require "major personal or financial sacrifices." *In re Lewis*, 2020 WL 489222, at *3 (Bankr. S.D. Miss. Jan. 29, 2020) (internal citations omitted). That court denied a student loan discharge where the debtor, a 40 year old who made over $92,000 a year and was the mother of two children, would have payments of $1,200.00 per month over thirty years, but only $506 per month for the REPAYE program over the course of 25 years *Id*.

It is not clear how the best interpretation of the *Brunner* test contemplated by the Proposed Test would handle a student loan with a thirty-year repayment period, but there is at least a good possibility that a case with the facts articulated above would come out differently under the Proposed Test, especially considering the significantly higher monthly payment which would be imposed by a ten-year repayment period envisioned under the Proposed Test.

The Fifth Circuit recently cited directly to *Frushour*, discussed above, in writing this: "as the Frushour court explained, 'Inability to pay one's debts by itself cannot be sufficient; otherwise all bankruptcy litigants would have undue hardship. The exception would swallow the rule, and Congress's restriction would be meaningless.'" *In re Thomas*, 931 F.3d 449 (5th Cir. 2019) *quoting Frushour*, 433 F.3d at 399. The *Thomas* court specifically mentioned that only an act of Congress could alter the *Brunner* test is was applied in its circuit, and that "the role of this [C]ourt is to interpret the laws passed by Congress, not to set bankruptcy policy." *Thomas*, 931 F.3d at 455,

Another recent case from a court in the Fifth Circuit held that "The *Brunner* test must be strictly construed, and equitable concerns or other extraneous factors not contemplated by the test may not be imported into the analysis. To do otherwise would go against Congress's intent to make student loan debt discharges available only in exceptional circumstances." *In re Little*, 607 B.R. 853, 858 (Bankr. N.D. Tex. 2019) (internal citations and quotations omitted). This decision endorsed the "certainty of hopeless" requirement to the second prong of the *Brunner* test, and approvingly cited a case where an unemployed sixty-two year old's diabetic neuropathy could not

be considered an additional circumstance evidencing hardship to repayment, because that debtor should still have been able to perform sedentary work. *Id*. at 859.

The most recent case from any bankruptcy court in the Fifth Circuit also comes from Texas, and interestingly, does not explicitly mention "the certainty of hopelessness" standard, although the case does state that "[t]he Fifth Circuit has made clear that Congress clearly evinces an intent to limit bankruptcy's use as a means of offloading student loan debt except in the most compelling circumstances." *In re Trejo*, 2020 WL 1884444, at *5 (Bankr. N.D. Tex. Apr. 15, 2020). The bankruptcy court out of the Northern District of Texas granted the debtor in *Trejo* a full discharge, but her circumstances were quite difficult. She was an older woman who had children with significant health issues and lived predominately on a part-time job, her daughter's SSI, and food stamps, so the case likely does not mark a sea change in the Fifth Circuit.

The Sixth Circuit

In 2018, the Sixth Circuit BAP was urged to adopt the totality of the circumstances test used in the First and Eight Circuits but found that it had no authority to do so under circuit precedent. The Sixth Circuit BAP also approvingly cited the "certainty of hopelessness" language:

> [T]he Debtor argues that the bankruptcy court should not have applied the Brunner test. He says that requiring a debtor to show the existence of unique or extraordinary circumstances amounting to a certainty of hopelessness is not supported by the text of § 523(a)(8). He states that a better, more reasonable test can be found in the First and Eighth Circuits in the form of a "totality of the circumstances" test. Nevertheless, the Sixth Circuit Court of Appeals has adopted the Brunner test, not a totality of the circumstances test. Even assuming the time has come to revisit Brunner, unless and until the Sixth Circuit Court of Appeals does so, the bankruptcy courts in this circuit, as well as this Panel, are obligated to apply it.

In re Chenault, 586 B.R. 414, 421 (B.A.P. 6th Cir. 2018) (internal citations and quotations omitted).

In line with the stricter interpretation of the *Brunner* test, a court in the Sixth Circuit held in August 2019, that among other factors, a student loan was not an undue hardship when a debtor could reduce (but had not already reduced) his monthly payment to $63-$94 per month through an income-based repayment plan, and that debtor paid several hundred dollars per month for internet, phone, and DirecTV service. *In re Murrell*, 605 B.R. 464, 471 (Bankr. N.D. Ohio 2019).

The most recent case from the Sixth Circuit continues to endorse the "certainty of hopelessness" standard, but it did, in a footnote, offer a brief summary of the criticisms of that standard. *In re Hutsell*, 2020 WL 6336224, at *6 (Bankr. N.D. Ohio Aug. 19, 2020):

> The "certainty of hopelessness" language has been specifically criticized as going beyond the language of § 523(a)(8) and the Brunner opinion. *See, e.g., Krieger v. Educ. Credit Mgmt. Corp.*,

713 F.3d 882, 885 (7th Cir. 2013) (noting that the "certainty of hopelessness" language "sounds more restrictive than the statutory 'undue hardship[ ]' "); *see also Educ. Credit Mgmt. Corp. v. Polleys*, 356 F.3d 1302, 1310 (10th Cir. 2004) (largely adopting the Brunner test but explaining that when "applying [the second] prong, courts need not require a 'certainty of hopelessness.' Instead, a realistic look must be made into debtor's circumstances and the debtor's ability to provide for adequate shelter, nutrition, health care, and the like."); *Rosenberg*, 610 B.R. at 458-59 (citing cases for the proposition that the punitive nature of the Brunner test, including "the certainty of hopelessness" standard, is largely a result of cases interpreting Brunner rather than the decision itself).

That footnote is interesting considering that the bankruptcy court granted the debtor a student loan discharge in the case, indicating that the court may be suggesting a move away from the "certainty of hopelessness" standard might have been appropriate. The debtor/plaintiff in *Hutsell* was a forty-seven-year-old with only a high school education, and significant long-term health issues including lasting complications from thyroid cancer. Based on those facts, the court likely did not have to pivot away from the "certainty of hopelessness" standard in order to rule in the debtor's favor (which it did), but the footnote may be an indication that it wished it had the authority to do so in a case with less stark facts.

The Eleventh Circuit

The Eleventh Circuit is a "certainty of hopelessness" circuit, and along with the Fifth Circuit, they are perhaps the most difficult circuits in which to receive a student loan undue hardship discharge, based on the most recent case law. A case as recent as October 2019 holds that only "rare circumstances" will result in a student loan discharge. *In re Montevechi*, 2019 WL 5204459, at *3 (Bankr. M.D. Fla. Oct. 15, 2019) ("A debtor does not satisfy the second prong by merely demonstrating employment in a low paying career without much opportunity for improvement – especially where the debtor's work history and resume allows for better employment opportunities. Instead, a debtor must be faced with a 'certainty of hopelessness' because the debtor will never be able to pay the student loans for reasons outside of the debtor's control. Only a debtor with rare circumstances will satisfy the second prong of the Brunner test").

Courts in the Eleventh Circuit also explicitly consider whether debtors have attempted to restructure their payments. *In re Beece*, 2019 WL 1769605, at *2 (Bankr. M.D. Fla. Apr. 18, 2019) ("Debtors must show a "certainty of hopelessness" not just the debtor's current "inability to fulfill a financial commitment. A debtor must show that circumstances out of his or her control created the complete inability to pay future debts… Although not determinative, an important factor courts must evaluate in determining good faith is whether a debtor attempted to negotiate a less burdensome repayment plan.").

The *Beece* court's interpretation of "minimal standard of living" is dissimilar from the Proposed Test's "reasonableness" standard. *Id.* "Debtors are not entitled to maintain whatever

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standard of living he or she has previously attained, nor the level he or she would maintain if required to repay the debt. Minimal does not mean preexisting, and it does not mean comfortable." *Id.*

The most recent case from the Eleventh Circuit, decided in the Northern District of Georgia in August 2020, continues to reference the "certainty of hopelessness" standard. *In re Manigault*, 2020 WL 4939170, at *4 (Bankr. N.D. Ga. Aug. 24, 2020).

D. Discussion Points

1. Within the Second Circuit, courts have cited the Report both with approval, and with skepticism. Is the Proposed Test close enough to the *Brunner* test to be viable as a common law "best interpretation," or would it require new legislation and/or or a Supreme Court decision for the Proposed Test to be broadly adopted?

2. A flashpoint in some courts is whether a debtor should have to affirmatively prove an attempt to repay in good faith, or if a debtor merely must show that the debtor did not act in bad faith. Based on the Proposed Test, the Commission must see this as more than a semantic difference. Is it more than a semantic difference, and how might it play out differently in section 523(a)(8) litigation under either theory?

3. Another frequent point of contention is whether a court may consider whether a debtor has attempted to apply for income-based repayment programs, and whether the court may consider the terms of those programs in determining undue hardship. The Report endorses the view that consideration of monthly payment under income-based programs should be minimal, or not considered at all. Is it better policy to consider the payoff balance as opposed to the monthly payment when determining undue hardship, because reasonable and affordable monthly payments programs exist that may significantly improve a debtor's financial circumstances? Does it undermine income-based repayment programs, which are widely effective tools for many student loan borrowers, to disregard them in the bankruptcy context?

4. Some student loan borrowers have argued that income-based repayment plans may leave them with a significant tax penalty upon the ultimate discharge of the balance of their student loans upon completion of the plan, and at least some courts have considered this argument when deciding whether the an income-based plan may still present an undue hardship even if the monthly payment is very low. Student loan creditors argue that the tax penalty is purely speculative, and finding undue hardship based on that speculative penalty thwarts the intent of the income-based repayment program. Would it make sense for the Commission to propose a change to the Internal Revenue Code to ensure the absence of tax consequences to each income-based repayment program? Current law exempts debt forgiven through the Public Service Loan Forgiveness Program from taxation.

5. Is the "certainty of hopelessness" standard – which is still referenced in at least three circuits– a proper application of the *Brunner* test? Is it a legally colorable application, or is the trend away from this standard?

Discussion of Selected Recommendations Regarding Attorney Competency

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I. Background

A. The Commission recognized the prior work of ABI's National Ethics Task Force in identifying the basic elements of competently representing consumer debtors:

> *(1) A lawyer should understand and be able to communicate to his or her client the advantages and disadvantages of bankruptcy as a debt-relief remedy.*
> *(2) A lawyer should be familiar with the information necessary to prepare a bankruptcy case. In addition, the lawyer must have developed efficient and effective systems and procedures to obtain from the client the information and documentation required by the Bankruptcy Code.*
> *(3) A lawyer should be aware of the Bankruptcy Code provisions mandating certain disclosures by the lawyer. A lawyer should also know what types of information he or she is required to communicate to consumer debtor clients.*
> *(4) A lawyer should know how to efficiently and effectively prepare and file a bankruptcy petition and the related schedules, statements and other necessary documents.*
> *(5) A lawyer should understand the consumer bankruptcy case process and system and have the skills to represent the debtor's interests diligently in connection with the case proceedings, keep his or her client informed, provide ongoing advice and responses to the debtor's inquiries, and be responsive to inquiries and requests made by the court and by other professionals in the case.*[1]

And the Commission recognized that while many lawyers meet these minimum criteria and, in fact, many practice skillfully, all too often the bankruptcy system is presented with lawyers whose practices are substandard or who engage in intentional misconduct.

[1] Final Report of the ABI National Ethics Task Force 68-73 (2013) (available at https://abi-org.s3.amazonaws.com/Endowment/Research_Grants/Final_Report_ABI_Ethics_Task_Force.pdf) (last visited March 5, 2020).

B. Lawyers who engage in substandard and unethical practices cause harm across the bankruptcy system: to their clients, to bankruptcy estates and creditors, and to the integrity of the bankruptcy process.

C. United States Trustees are the watchdogs of the bankruptcy system,[2] and have standing to raise and be heard on almost any issue in bankruptcy cases.[3] The United States Trustee Program (USTP) has long been engaged in civil enforcement efforts to redress the harm caused by the small number of consumer debtor lawyers who place their interests ahead of their clients' interests, ignore their obligations under the Bankruptcy Code,[4] Bankruptcy Rules, and applicable rules of professional conduct and ethical standards, or who engage in fraud or intentional misconduct. As the Commission acknowledged, beginning in 2016 the USTP deployed a national strategy to address these problems.

D. Over the past three fiscal years (2017-2019) the USTP has filed between 500 and 600 formal actions per year related to attorney competency and conducted informal inquiries in many more cases.[5]

E. The USTP's actions have addressed a number of improper practices, including:

- Misconduct related to bifurcation and "factoring" of fees, including failure to provide critical advice and services, inadequate disclosures to clients and in court filings, and overcharging;[6]
- Failure to obtain client signatures before filing bankruptcy petitions;
- Unreasonable delay in filing cases after being paid in full; and
- Circumventing the Bankruptcy Code's credit-counseling requirements.

F. Examples of Significant USTP Enforcement Actions:

1. *Matter of Husain*, 866 F.3d 832 (7th Cir. 2017). The Seventh Circuit Court of Appeals affirmed the bankruptcy court's disbarment (or, in the bankruptcy court's terminology, "permanent suspension") of an attorney who, among other things, routinely forged clients' signatures on documents that must be verified under

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[2] H.R. Rep. No. 95-595, at 99 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6049.
[3] 11 U.S.C. § 307.
[4] 11 U.S.C. §§ 101 *et seq.*
[5] https://www.justice.gov/ust/file/Formal_Enforcement_Actions_FY13_19_1.xlsx/download (last visited March 5, 2020).
[6] *See, e.g., In re Milner*, 611 B.R. 416 (Bankr. W.D. Okla. 2019), *In re Wright,* 591 B.R. 68 (Bankr. N.D. Okla. 2018); *but see In re Hazlett*, No. 16-30360, 2019 WL 1567751 (Bankr. D. Utah Apr. 10, 2019).

penalty of perjury, including on bankruptcy schedules that failed to disclose all of the debtors' assets; filed bankruptcy petitions on behalf of ineligible debtors; and lied under oath in the disciplinary proceeding. The court of appeals found the attorney's "everyone does it" defense unavailing.

2. *Hobbs v. Chesson*, Misc. Proc. No. 16-00201, 2018 WL 4172667 (Bankr. W.D. La. Aug. 29, 2018). The bankruptcy court found that the defendants—a bankruptcy attorney and his law firm—violated sections 526(a)(1), (a)(2), and 528 of the Bankruptcy Code by routinely having the law firm's staff impersonate clients to obtain credit counseling certificates, then filing false credit counseling certifications with the bankruptcy court. The court concluded that the firm engaged in a pattern or practice of violating section 526 of the Bankruptcy Code, as well as violating section 528 in some cases, and imposed disgorgement, a civil penalty, and nonmonetary remedial relief, including changes to the firm's practices and procedures. The court also suspended the firm's principal from practice in the bankruptcy court for 90 days and referred him to the district court for disciplinary action with a recommendation for a one-year suspension.

3. *Allen et al. v. Fitzgerald*, Civ. Act. No. 7:18-00134, 2019 WL 6742996 (W.D. Va. Dec. 11, 2019), *affirming in part and vacating in part Robbins v. Delafield (In re Williams)*, No. 15-7176, Adv. No. 16-02024, 2018 WL 832894 (Bankr. W.D. Va. Feb. 12, 2018). The district court affirmed the bankruptcy court's suspension of a national consumer law firm from practice in the district for five years, and remanded the case for further proceedings on the firm's (and its jointly and severally liable former principals') ability to pay the large monetary sanctions imposed by the bankruptcy court. The district court found that the bankruptcy court could impose the practice ban under its inherent power to discipline those who practice before it, which extends to attorneys and firms who may not themselves may not be members of that court's bar but whose non-lawyer employees "were consistently engaged in the unauthorized practice of law affecting the bankruptcy court." The district court also found that the defendants' conduct, including the unauthorized practice of law and participation in a program under which debtors would "surrender" their financed automobiles to a third party in exchange for payment of their bankruptcy attorneys' fees, supported significant monetary sanctions.

4. *In re Cook*, 610 B.R. 852 (Bankr. N.D. Ill. 2019). The bankruptcy court imposed a civil penalty against the same national consumer law firm for its pattern and practice of failing to fully and accurately disclose its clients' pre-petition Fair Debt Collection Practices Act (FDCPA) claims and settlements, even though the firm represented the clients in both the FDCPA litigation and the bankruptcy case.

The court also held the firm's former principals jointly and severally liable for all of the United States Trustee's attorney's fees and expenses as a sanction for the firm's litigation misconduct, finding that the firm "abused the judicial process . . . engaging in multiple discovery abuses and pushing unreasonable litigation positions."

II. Commission Recommendation – More Vigorous Use of Existing Disciplinary Tools

§ 3.04(a) – Individuals and organizations with enforcement and disciplinary responsibility for attorneys in bankruptcy – including individual attorneys, case trustees, bankruptcy judges, the Office of the United States Trustee, state bar disciplinary committees, and United States Attorneys – should diligently and vigorously employ the many tools available to address attorney misbehavior.

A. Here, the Commission recognizes the various remedies that already exist to address attorney underperformance and misconduct. The Final Report refers to:

- The bankruptcy courts' inherent powers, and authority under section 105 of the Bankruptcy Code, to regulate their bars and to sanction contempt.
- The federal vexatious litigant statute (28 U.S.C. § 1927), which provides that "An attorney or other person admitted to conduct cases in any court of the United States . . . who so multiples the proceedings in any case unreasonably or vexatiously may be required by the court to satisfy personally the excess costs, expenses, and attorneys' fees reasonably incurred because of such conduct."
- Bankruptcy Rule 9011, which provides that attorneys or unrepresented parties must sign all papers; that by filing or presenting a paper to the court, an attorney or unrepresented party certifies that, to the best of the person's knowledge, information, and belief after a reasonable inquiry, the paper is not being presented for an improper purpose, does not contain claims, defenses, or legal contentions that are unwarranted by existing law or are not a frivolous argument for modification of existing law; and that violations of the rule may be sanctioned (subject to certain requirements, including the "safe harbor" discussed below).[7]
- Bankruptcy Rule 7037 (incorporating Civil Rule 37, including sanctions for discovery misconduct).[8]

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[7] Fed. R. Bankr. P. 9011.
[8] Fed. R. Bankr. P. 7037.

- Bankruptcy Rule 3002.1, which by its terms provides consequences for claimholders that fail to comply with certain requirements under the Rule but does not directly relate to attorney competency or misconduct.[9]
- Section 329 of the Bankruptcy Code, which requires attorneys representing debtors to fully disclose the compensation paid within a year before the filing of the petition, or agreed to be paid, and provides that the bankruptcy court may limit such compensation to the reasonable value of the services rendered.[10]
- Section 707(b)(4) of the Bankruptcy Code, which may require the debtor's attorney to pay reasonable costs, including attorneys' fees, associated with a successful section 707(b) motion if the court finds that the filing of the bankruptcy case violated Bankruptcy Rule 9011, permits assessment of civil penalties for attorneys who violate Bankruptcy Rule 9011, and also imposes certification requirements.[11]
- Referrals by bankruptcy judges, trustees, and U.S. Trustees to state licensing or disciplinary authorities and United States attorneys.

The Commission concluded that these remedies and tools are adequate, and "there is not a need for new substantive provisions to address attorney misconduct."

B. Some of these tools and remedies present their own challenges, which the Final Report acknowledges. For example, there is some dispute in the law as to whether bankruptcy courts are "courts of the United States" for purposes of 28 U.S.C. § 1927. And the "safe harbor" provisions of Bankruptcy Rule 9011 allow an attorney to withdraw a document that violates the rule prior to facing sanctions.

C. The Final Report is silent as to the "debt relief agency" [12] provisions, sections 526, 527, and 528 of the Bankruptcy Code. Attorneys are debt relief agencies if they satisfy the statutory definition.[13]

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[9] Fed. R. Bankr. P. 3002.1.
[10] 11 U.S.C. § 329.
[11] 11 U.S.C. § 707(b)(4).
[12] A debt relief agency is "any person who provides any bankruptcy assistance to an assisted person in return for the payment of money or other valuable consideration" with certain exceptions. 11 U.S.C. § 101(12A). "Bankruptcy assistance" is "any goods or services sold or otherwise provided to an assisted person with the express or implied purpose of providing information, advice, counsel, document preparation, or filing, or attendance at a creditors' meeting or appearing in a case or proceeding on behalf of another or providing legal representation with respect to a case or proceeding under this title." 11 U.S.C. § 101(4A). An "assisted person" is "any person whose debts consist primarily of consumer debts and the value of whose nonexempt property is less than $192,450." 11 U.S.C. § 101(3).
[13] *Milavetz, Gallop & Milavetz, PA v. United States*, 559 U.S. 229, 236, 130 S. Ct. 1324, 1331 (2010).

1. Section 526(a) prohibits various categories of misconduct, including failing to perform promised services, making (or counseling a debtor to make) untrue or misleading statements in bankruptcy documents, misrepresenting services or benefits and risks of filing bankruptcy, or advising an "assisted person" to incur debt in contemplation of filing a bankruptcy case or in order to pay an attorney's or petition preparer's fees. Section 527 prescribes the notices that a debt relief agency must provide to an assisted person. Section 528 requires debt relief agencies to promptly enter into clear written agreements for services with assisted persons and also imposes advertising requirements for bankruptcy services.

2. Section 526(c) contains the remedies for violating the "debt relief agency" provisions, which include voiding noncompliant contracts; liability to the assisted person for damages, attorney's fees, and costs; and civil penalties and injunctive relief as a remedy for a "pattern and practice" of section 526 violations.[14]

D. The debt relief agency provisions are arguably crafted to address the most serious forms of misconduct, including severe and intentional acts and widespread deficiencies and misconduct by national or multijurisdictional firms. And the Final Report acknowledges some cases involving those types of misconduct.

1. Section 526 has been used to sanction, for example, intentional misconduct by an attorney who advised a client not to disclose a debt owing to a family member (and a payment made on it) in bankruptcy schedules.[15]

2. It has also been used to impose a civil penalty against a firm that demonstrated a pattern of the same material omissions across cases.[16]

E. Points for Discussion

1. Are existing remedies for attorney misconduct and underperformance adequate to redress problems that arise in current bankruptcy practice, especially misconduct by large-scale actors?

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[14] *See Id.* at 232 ("In order to improve bankruptcy law and practice, Congress enacted through the BAPCPA a number of provisions directed at the conduct of bankruptcy professionals").
[15] *Bisges v. Gargula (In re Clink)*, 770 F.3d 719, 722-23 (8th Cir. 2014).
[16] *Cook*, 610 B.R. at 865.

2. Is there room, or a reason, to expand or strengthen any of the Code's provisions that address attorney behavior?

III. Commission Recommendation – Implementation of Local Disciplinary Bodies

§ 3.04(b) – Increased enforcement of existing rules carries with it at least two burdens: an increased workload on those enforcing the rules, and the conflict inherent in bankruptcy judges simultaneously undertaking the roles of investigator, prosecutor, hearing officer, and final arbiter. These burdens can be at least partially addressed by the formation of committees or other bodies at the local level charged with investigating and resolving complaints against offending attorneys. These bodies could be staffed by judges, local attorneys, or a combination of the two

§ 3.04(c) – Any such local bodies, and the procedures governing them, should be approved by the relevant bankruptcy and district courts and should be adopted as local rules. Some districts have already implemented such systems. In smaller districts, the extension of existing cooperation regarding caseloads among adjacent districts should be extended to include assistance in addressing improper behavior.

A. With these recommendations the Commission, for several reasons, advocates for the implementation of disciplinary panels or committees to address attorney misconduct. The Commission further recommended that these processes be implemented by local rule.

B. Many, but not all, jurisdictions already have established disciplinary processes either at the bankruptcy court or district court level, taking on different forms. Experience suggests that these processes work well. The Final Report reviews some of the variations of these processes, which include the composition of the panels and procedural details.

C. The existence of these processes, and the Commission's endorsement of them, are a reaffirmation of the principle that bankruptcy courts have inherent authority to regulate the attorneys who practice before them.

D. Points for Discussion

1. Existing disciplinary processes are implemented locally, and the Commission recommends that they continue to be created and implemented through local

rules. Does this kind of localized implementation make sense, or would there be benefits to greater uniformity across the bankruptcy system?

2. The report suggests that there is a benefit to separating disciplinary proceedings from the underlying bankruptcy case, and the judge who adjudicated the underlying case. Are there circumstances in which the bankruptcy judge familiar with the facts surrounding an attorney's alleged misconduct is better positioned to determine whether (and what kind) of discipline is appropriate?

3. How can local disciplinary processes be employed to address multijurisdictional, or national, misconduct?

IV. Commission Recommendation – Incentives for Exceptional Practice

§ 3.04(d) – In addition to the sting of sanctions, courts and other entities should also employ incentives to practice ethically. In this regard, one incentive should be consistently awarding enhanced fees to professionals who are "board certified or [who have] otherwise . . . demonstrated skill and experience in the bankruptcy field," as authorized by 11 U.S.C. § 330(a)(3)(E). This enhancement should be implemented by local court rules, which should provide details encouraging compliance, such as permitting defined enhancements when the representation is by a firm in which some, but not all, of the attorneys have been board certified.

A. This recommendation reflects the Commission's carrot-and-stick approach by balancing sanctions with positive financial incentives.

B. As the recommendation notes, the Code already provides for bankruptcy courts to award enhanced fees to professionals in certain circumstances.[17] Chapter 7 counsel are not employed by the estate and so are not directly covered by section 330,[18] but the Commission imports the principle.

C. Points for Discussion

1. The Commission's recommendation acknowledges the potential for mischief under this proposal—for example, a large firm might attempt to use the board certification of one or a few of its attorneys to obtain enhanced fees in all of its

[17] 11 U.S.C. § 330(a)(3)(E).
[18] *See Lamie v. United States Trustee*, 540 U.S. 526, 124 S. Ct. 1023 (2004).

cases, including those not directly handled by the board-certified attorneys. What can be done to properly structure incentives to avoid this kind of gamesmanship?

2. What is the appropriate baseline for approving enhanced fees? Presumably, it is a higher standard than merely meeting minimal standards of professionalism, ethics, and competency.

3. Would expanded use of these kind of positive incentives for exceptional practice inadvertently increase the fees for the best attorneys beyond what debtors with average, or less-than-average, resources can afford?

PART THREE: Discussion of Selected Recommendations Regarding Attorney Compensation

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I. Introduction

Few topics touch as many issues that are critical to the availability and effectiveness of bankruptcy as the rules and statutes related to attorneys' fees charged by bankruptcy practitioners representing debtors. Regulating how attorneys' fees may be charged, disclosed, and collected impacts not only the access of an individual to the relief offered by bankruptcy, but also the ability of an attorney to build a productive and profitable practice. Seeking to balance the needs of all parties to the bankruptcy process, the ABI Commission on Consumer Bankruptcy (the "Consumer Commission") addressed the issues related to attorneys' fees in bankruptcy and developed a number of recommendations in its final report.

II. The Final Report (the "Final Report") of the ABI Commission on Consumer Bankruptcy Provisions Related to Attorneys' Fees

The Consumer Commission addressed debtors' attorneys' fees in both chapter 7 and 13 cases. The recommendations in the Final Report include the following.

a. **The dischargeability of prepetition attorney's fees in chapter 7 hinders access to the bankruptcy system and access to justice. Congress and all stakeholders to the bankruptcy system should take steps to lower barriers to access, including:**

  (1) consistent with the Commission recommendation at § 5.06 Bankruptcy Forms, creating easy-to-understand online data input forms that would generate asset and liability compilations that could be reviewed by a bankruptcy professional to make preparation of schedules less time-consuming;

  (2) increasing provision of pro bono bankruptcy representation for low-income debtors;

  (3) reducing filing fees for low-income debtors, even if represented by paid counsel;

  (4) allowing video attendance at § 341 meetings and scheduling these meetings outside of regular working hours, with safeguards ensuring that the named debtor is the one appearing; and

(5) providing low-income debtors legal representation through a governmental office, akin to public defenders' offices.

b. Congress should amend the Bankruptcy Code to allow post-petition payment for attorney services rendered prepetition. Different mechanisms have different costs and benefits. The Commission believes two mechanisms merit consideration:

(1) Excepting fee agreements from the automatic stay and delaying the discharge of fees for a period of time, such as six months, with other coordinating amendments to the Bankruptcy Code to ensure no change to other creditors' access to their collateral during the delay.

(2) Making prepetition attorney's fees nondischargeable in a chapter 7 with judicial review of the fee agreement.

c. Presumptively Reasonable Attorney's Fees in Chapter 13s

(1) In chapter 13 cases, courts should adopt presumptively reasonable flat fees that cover typical attorney work until confirmation.

(2) Courts should adopt an "a la carte" fee structure for work performed after confirmation.

(3) Courts should consider consumer bankruptcy specialist certification as a factor in setting presumptively reasonable fees.

(4) Courts should review presumptively reasonable fees on a regular basis to determine whether they are promoting the goals of efficiency, a qualified bar, the diligent practice of law, and fairness to debtors.

d. Unbundling of Legal Services. Bankruptcy courts should adopt local rules that address unbundling, specifying what services a lawyer may and may not exclude from the legal representation being provided. The courts should ensure that these local rules are consistent with applicable rules of professional responsibility.

III. Impact of Politics and the Pandemic on Attorneys' Fees

The Consumer Commission addressed a number of issues throughout its report that touched on the overall cost of and access to consumer bankruptcy. Some recommendations would require legislative changes, others require adoption of certain practices and procedures by the various courts or the regional offices of the U.S. Trustee.

A. Pandemic Brings Swift Changes

Recommendation § 3.01(a)(4): ***Allowing video attendance at § 341 meetings***

In April of 2020, the U.S. Trustee change its policies on attendance at 341 hearings, audits and stimulus payments in response to the COVID-19 pandemic. Section 341 meetings were immediately shifted to telephonic or video means to avoid in-person gatherings. The U.S. Trustee also suspended the auditing of bankruptcy cases and issued a policy statement discouraging the administration of CARES Act stimulus payments. By most accounts, the remote meetings have gone well and may encourage adoption of the same practice post-pandemic in line with the recommendation of the Commission to allow "video attendance at § 341 meetings and scheduling these meetings outside of regular working hours, with safeguards ensuring that the named debtor is the one appearing...." Further, the reduction attorney time required to attend in-person hearings may result in reduced costs to the consumer debtor, particularly in the price-sensitive competitive Chapter 7 market.

B. Potential Changes With New Presidential Administration

Recommendation § 3.01(a)(3): ***Reducing filing fees for low-income debtors, even if represented by paid counsel***

Recommendation § 3.01(b): ***Congress should amend the Bankruptcy Code to allow post-petition payment for attorney services rendered prepetition***

The election of Joe Biden increases the likelihood of more significant changes to the consumer bankruptcy system as a whole. Predicting legislative changes is difficult, but the new administration has made clear at least its position on bankruptcy reform. In fact, while still campaigning, in March of 2020, Biden publicly endorsed the Elizabeth Warren plan for bankruptcy reform.[1]

Warren's bankruptcy plan envisions an overhaul to consumer bankruptcy in general, with the ultimate goal of reducing costs, increasing access, and enlarging relief for consumers with student loan debt.[2] One fundamental change called for by Warren would be to permit a consumer debtor's attorney's fees to be paid post-petition over time. Warren's plan would also eliminate the filing fee otherwise paid to the Clerk's Office for any debtor below the federal poverty level. The plan further seeks to reduce the overall expense of consumer bankruptcy with fundamental changes to the chapters to streamline the process, reduce documentation demands, and eliminate credit counseling requirements.

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[1] *Americans' Debts Are Mounting, Putting New Focus On Biden's Role Opposing Bankruptcy Protections*, The Washington Post, (Oct. 27, 2020 at 6:00 a.m. EDT).
[2] *See* Elizabeth Warren, *Fixing Our Bankruptcy System to Give People a Second Chance*, https://elizabethwarren.com/plans/bankruptcy-reform (last visited November 13, 2020).

IV. Review and Update of Chapter 7 Attorney Fee Practices Related to the Unbundling of Services and the Payment of Fees Post-petition

Recommendation § 3.02: ***Unbundling of Legal Services. Bankruptcy courts should adopt local rules that address unbundling, specifying what services a lawyer may and may not exclude from the legal representation being provided. The courts should ensure that these local rules are consistent with applicable rules of professional responsibility.***

The most significant changes to the structure of attorney compensation recommended by the Consumer Commission would require legislative changes to permit the payment of post-petition attorneys' fees by debtors in bankruptcy. While Congress certainly has not taken such action since the publication of the Report, some debtors' attorneys have developed and implemented unbundling and bifurcation practices that, if successful and approved by the courts, would arguably have similar effects. The remainder of this paper will explore the various forms of unbundling and bifurcation utilized by some consumer practitioners in order to attempt to avoid charging full attorney's fees prior to the filing of a case and will also review issues related to the factoring and financing of attorney's fees charged post-petition.

A. Background

There is at least one thing that is certain in the world of Chapter 7 bankruptcy practice. Attorneys want to be paid for the services that they render to the debtor. There is a second thing that is almost as certain. Most debtors are willing to pay a reasonable fee for those services in order to receive a discharge of their personal debts. The bankruptcy code prevents attorneys and Chapter 7 debtors from entering into a contract that will allow them to reach both of these goals if the debtor does not pay the attorney at least some, if not all, of his or her fees before the attorney files the case. The problem arises from the practical fact that at least some of the attorney's services must be rendered pre-petition, thus giving rise to a pre-petition debt owed by the debtor to the attorney, and the legal fact that the bankruptcy code provides that any claim arising from a pre-petition debt is dischargeable.

As one court has observed:

> Chapter 7 attorney fees are not obligations that are compensable from the bankruptcy estate, thus a Chapter 7 lawyer must, in a perfect world, collect his fee in full from the debtor pre-petition. Because Chapter 7 debtors often do not have sufficient funds to pay attorney fees up front, lawyers often enter into pre-petition agreements allowing debtors to pay part of the fees pre-petition and the balance of the fees post-petition. This arrangement, however, runs afoul of the general rule that pre-petition debts are dischargeable.

In re Abdel-Hak, 2012 Bankr. LEXIS 5393 (Bankr. E.D. Mich. 2012).

B. Unbundling Defined

Because debtors do not generally have the funds sufficient to pay Chapter 7 legal fees before the attorney begins rendering services, some Chapter 7 attorneys have devised a variety of methods to ensure payment. These methods are referred to collectively as "unbundling."

> Unbundling is the practice of limiting the scope of services that an attorney will provide—"dividing comprehensive legal representation into a series of discrete tasks, only some of which the client contracts with the lawyer to perform."
>
> *In re Seare*, 493 B.R. 158 (Bankr. D. Nev. 2013).
>
> Instead of traditional representation, where a lawyer handles a case from start to finish, limited scope representation, also known as "unbundling" or "discrete task representation," involves representation in which a lawyer performs some, but not all, of the work.
>
> *In re Ruiz*, 515 B.R. 362 (Bankr. M.D. Fla. 2014).

In Chapter 7, unbundling typically consists of dividing legal services into at least two bundles. The first concerns services that are rendered pre-petition and the second concerns services that are rendered post-petition.

C. Forms of Unbundling: How Many Contracts?

Attorneys employ a number of variations on the unbundling theme in order to achieve the ultimate goal, that is, the payment of their fees. One way to analyze these different approaches is to divide the variations into the number of fee contacts that the attorney enters into with the debtor. Attorneys use one, two, and even zero contracts (sometimes referred to as ghostwriting) to set forth the terms of the complete bankruptcy representation in an attempt to assure payment of their fees. Each method has its weaknesses.

1. One Contract.

Under the single contract method, the attorney and the debtor execute a single contract that covers services rendered both pre-petition and post-petition. In some cases, the contract designates what services will be rendered pre-petition and what services will be rendered post-petition. Some of these contracts will also designate what portion of the fees is for pre-petition services and what portion of the fees is for post-petition services. While all courts hold any unpaid debt based upon a claim for pre-petition services to be dischargeable in Chapter 7, the courts are in disagreement regarding whether an attorney can collect unpaid fees for post-petition services based on a pre-petition contract.

a. One Contract – Fees Earned Post-petition Not Dischargeable

Some courts have held that fees earned pre-petition are dischargeable if not paid at the time that the contract is executed and that the fees that are earned post-petition are not dischargeable. These courts tend to require evidence concerning the division of services into those that are rendered pre-petition and those that are rendered post-petition before any post-petition fees may be allowed. These courts also tend to award post-petition fees under a theory of *quantum meruit* if the attorney is discharged by the debtor before all services are rendered.

In *In re Hines*, 147 F.3d. 1185 (9th Cir. 1998), the debtor's first attorney filed a Chapter 13 petition on behalf of the debtor. A year later, the debtor consulted a second attorney who recommended that she convert the case to Chapter 7. The debtor signed a promissory note and provided the second attorney with seven checks, the first to be cashed pre-conversion and the other six to be cashed post-conversion. The second attorney cashed the first checks prior to conversion. After the case was converted to Chapter 7, the second attorney cashed two more of the checks.

The debtor then returned to the first attorney who advised her that she should not pay the remaining fees owed to the second attorney because they became dischargeable upon the conversion of the case. The Bankruptcy Court reduced the fees allowed to $375.00, the amount that had been paid to the second attorney by the debtor. The debtor appealed to the Bankruptcy Appellate Panel which reversed and remanded the case to the bankruptcy court for a determination of damages for violating the stay. The second attorney appealed to the Ninth Circuit Court of Appeals.

The Ninth Circuit held:

> In sum, we determine that as of the time that [the debtor] fired [the second attorney] to return to [the first attorney] as her attorney, [the second attorney] did have an undischarged claim for any fees earned by him in excess of the $375 that he had already collected via the first three $125 checks. To quantify that claim, [the second attorney] could not look to the entire remaining $500 that was originally contracted for, because [the debtor] (like any client) had the right to discharge him before he had completed his services.
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> *Hines* at 1191.

The holdings of the Ninth Circuit were three-fold. First, the Court held that fees based on post-petition services are not dischargeable. It follows that any such debt arising from the rendering of such services are not subject to the automatic stay. Second, the Court held that an attorney cannot be compensated under the contract if all of the services are not provided. Third, the Ninth Circuit held that an attorney who has not performed all services due under the fee agreement does, nonetheless, have a right to payment under the doctrine of *quantum meruit* to the extent of the value of the services that have been rendered. The Court held that § 362 is not implicated and the attorney could recover the value of services actually rendered because the services in question were rendered post-petition.

Those courts that agree with the holding in *Hines* tend to require that the fee agreement clearly distinguish between services that are to be rendered pre-petition and those that rendered post-petition. In *In re Michel*, 506 B.R. 99 (E.D. Mi. 2014), the debtor and attorney signed a pre-petition "flat fee" agreement and debtor paid $450.00 of the $900.00 fee pre-petition. The contract did not designate what amount was to be paid for pre-petition services and what amount was to be paid for post-petition services. After the § 341 meeting was concluded, the debtor paid the balance of $450.00. The U. S. trustee filed a motion to compel the attorney to disgorge the fees.

The *Michel* court held that attorney had to return the $450.00 paid post-petition to the debtor because the debtor's single pre-petition contract:

> … draws no distinction between pre-petition services and post-petition services to be rendered and does not in any way apportion the $900.00 flat fee... into a fee amount for pre-petition services and a fee amount for post-petition services. The Court agrees with those cases holding that this kind of pre-petition flat fee agreement in a Chapter 7 case creates a debt that is entirely a pre-petition debt, which therefore is subject to the automatic stay and is dischargeable in the Chapter 7 case.
>
> *Michel* at 106.

The Court denied the attorney's motion for compensation under a theory of *quantum meruit* based on other acts of the attorney that the Court found objectionable.

b. One Contract – Fees For Post-petition Work Under Pre-petition Contract Fully Dischargeable

Other courts have held that the attorney's claim for unpaid fees against the debtor under a Chapter 7 fee agreement gives rise to a debt that is wholly dischargeable in bankruptcy regardless of the distinction between pre-petition and post-petition services. In these cases, the Chapter 7 attorney may not collect any deficiency; the attorney must collect the entire amount of the fees at or before the time that the fee agreement is executed.

In *Bethea v. Robert J. Adams & Assocs.*, 352 F.3d 1125 (7th Cir.2003), *cert*. denied, 124 S.Ct. 2176, 158 L.Ed.2d 733 (2004), the Seventh Circuit Court of Appeals held that a pre-petition fee agreement gave rise to a debt that is subject to discharge. In *Bethea*, the debtors agreed to pay their Chapter 7 legal fees in installments, with some payments to be made pre-petition and some post-petition. The debtors received their discharges before paying all of the fees. They later hired a different attorney to contest the debt arising from the unpaid fees, claiming that it was discharged. The Seventh Circuit concluded that the retainer contract created a pre-petition, liquidated, dischargeable debt, and that § 329 does not create an unenumerated exception to the § 727(b) discharge. Accordingly, the bankruptcy attorneys were required to

refund to the debtors any money collected after the discharge and any money collected while the automatic stay was in effect. *Id.*, at 1129.

Thereafter, in *In re Griffin,* 313 B.R. 757 (Bankr. N.D. Ill. 2004), the debtor executed a single pre-petition fee agreement providing for a payment of fees in the amount of $1,150.00. He made a $100.00 down payment before the petition was filed. The *Griffin* court held that the attorney's unpaid claim arising under the Chapter 7 pre-petition fee agreement gave rise to a pre-petition debt that was dischargeable in the Chapter 7 case and therefore subject to the automatic stay. *Id.*, at 770.

c. One Contract – *Quantum Meruit* Considerations Regarding Dischargeability of Attorney Fees

Some courts have held that if the debt is not discharged, the attorney can recover under a theory of *quantum meruit* if the attorney is discharged by the debtor before completing all obligations under the fee agreement. *Quantum meruit* determines the amount to be paid for services when no contract exists or when there is doubt as to the amount due for the work performed but done under circumstances when payment could be expected.

In *In re Grimmett*, 2017 Bankr. LEXIS 1492 (D. Idaho 2017) (affm'd on appeal), the attorney and debtor executed a fee agreement pre-petition that provided for fees of $500.00 to be paid pre-petition for pre-petition services and $1,500.00 to be paid for post-petition services according a set schedule. The debtor fell behind on the payments. The attorney attempted to collect the fees. The U.S. Trustee filed a motion to cancel the agreement and compel the attorney to disgorge the fees.

The bankruptcy court ordered the disgorgement of all fees, but then allowed the attorney to collect post-petition fees on a theory of *quantum meruit*:

> The Court disagrees [with the attorney's argument that a debt arising from post-petition services are non-dischargeable]. The Agreement was executed before Debtor's bankruptcy case was filed. As a result, Debtor's obligation to pay him under the Agreement was discharged in bankruptcy, period, and Counsel cannot enforce that contract obligation post-petition. To get paid for any post-bankruptcy services it provided, Counsel must invoke quantum meruit. While *Hines* is a case about the scope of the automatic stay, it also reinforced the holding in *Biggar* that a lawyer cannot collect for pre-petition legal services because that obligation is discharged. Here, Counsel likewise may not rely on his pre-petition fee agreement to collect for fees incurred post-petition. Counsel must instead seek payment for post-petition services based solely upon equity.
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> *Grimmett*, at *27-28.

2. Two Contracts

Another approach to solving the fees problem in Chapter 7 attempted by some debtors' attorneys is to employ two contracts, one for pre-petition services and one for post-petition services.

a. **Initial Attempts at Bifurcated Fee Arrangements**

In *Walton v. Clark & Washington, P.C.*, 454 B.R. 537 (Bankr. M.D. Fla. 2011) ("*Walton I*"), the Chapter 7 attorney accepted postdated checks from the debtor as a pre-petition retainer. The Bankruptcy Court ruled that the Chapter 7 attorney was prohibited from accepting postdated checks as a pre-petition retainer for post-petition services that were to be provided to the debtor. The Court ruled that the postdated checks gave rise to pre-petition claims as a matter of law and that depositing the checks after the petition date violated the § 362 automatic stay or the § 524 discharge injunction (depending on when the check was deposited). The Court also ruled that the fee arrangement created a conflict of interest.

In response to the Court's opinion, the Chapter 7 attorney instituted a two-contract procedure under which the client executed one agreement for pre-petition services and a second agreement for post-petition services. After the debtor signed the pre-petition retainer agreement, the attorney prepared the petition and schedules. The attorney then filed the petition. Fourteen days after the attorney filed the petition, the debtor was given three options. The debtor could (1) proceed *pro se*; (2) retain the attorney to prosecute the Chapter 7 case; or (3) retain another attorney to prosecute the Chapter 7 case. If the debtor chose the second option, the parties entered into a post-petition retainer agreement. The client then made arrangements to pay the post-petition fees (generally in the form of automatic debits from the client's bank account) Thereafter, the attorney filed the balance of the schedules, statement of financial affairs, and other necessary documents.

The U.S. Trustee filed a motion to determine whether the attorney's new two-contract procedure violated the Court's prior ruling, resulting in a second opinion found at *Walton v. Clark 7 Washington, P.C.*, 469 B.R. 383 (Bankr. M.D. Fla. 2012) ("*Walton II*"). The Court cited two opinions for the proposition that a debtor may pay an attorney post-petition for post-petition legal services. As the Seventh Circuit recognized in *In re Bethea*, 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." *Bethea v. Robert J. Adams & Assocs.*, 352 F.3d 1125, 1128 (7th Cir.2003). The Supreme Court has also recognized that a debtor is free to use post-petition funds to pay for post-petition legal services. *Lamie v. Trustee*, 540 U.S. 526, 535-36, 124 S. Ct. 1023, 157 L. Ed. 2d 1024 (2004). The *Walton II* court concluded that it must uphold the validity of the two-contract procedure absent some compelling reason not to do so.

The Court further concluded that the attorney had addressed other concerns regarding its prior procedure by (1) more fully setting out the costs and fees associated with filing the client's case; (2) specifying the client's three options for post-petition legal services; and (3) explicitly disclosing in the Rule 2016 disclosure statement that the pre-petition fee was $250 and that the

contract between the client and the firm did not include post-petition services; and (4) setting out that the additional fee would be $1,000 in the event the debtor decided to retain the attorney for post-petition services. The attorney also agreed to represent the debtor during the two-week period post-petition and to enhance its notice of two-contract procedure that it provided to the debtor. The Court concluded that there is no prohibition against a debtor making post-petition installment payments for post-petition services.

In *In re Slabbinck*, 482. B.R. 576 (Bankr. E.D.Mich. 2012), the Court allowed the attorney to enter into two contracts with the debtor, one contract for pre-petition services and one contract for post-petition services. The Court rejected the U. S. Trustee's argument that the two fee agreements were essentially a single agreement giving rise to a pre-petition debt and the U.S. Trustee's the argument that the attorney could not "legally" unbundle the legal services into pre-petition and post-petition services. If there is a problem with using two contracts, it is generally caused by the local rules.[3]

b. Recent Opinions Addressing Bifurcated Fee Arrangements

i. Bifurcated Services with Factoring of Fees

The court in *In re Wright*, 591 B.R. 68 (N.D. Ok., Sept. 4, 2018) addressed the bifurcation of services into pre-petition and post-petition work, with the debtor's counsel also factoring the fees due under the second contract. Under the attorney's arrangement with the factoring company, the attorney would be paid 60% of the post-petition fee upon execution of the contract, with an additional 15% of those fees paid if the accounts were sufficiently paid by the debtors.

The U.S. Trustee filed a Motion for Review of Debtor's Transactions with Attorney, and the Court examined the same issue in seventeen other cases, *sua sponte.* The Court found that the attorney failed to disclose that he shared fees with any third party and that he conflated the total amount a debtor agreed to pay for his services with the amount that the attorney agreed to accept from the factoring company. The Court was troubled by the higher fees in the bifurcated cases, concluding that "BAPCA presents serious impediments to the legality of this kind of bifurcated services scheme…."

The Court further questioned the designation of services post-petition, finding that if the bulk of the work were truly completed post-petition, counsel would not be properly analyzing case. The actual time spent for pre-petition services was not consistent with the fee charged to pre versus post-petition services. The effect was to turn an otherwise dischargeable prepetition claim into a nondischarged claim, and "such a scheme works a fraud on both the debtor and the Court." Notwithstanding these stated concerns about the factoring and bifurcation arrangement, the Court limited its ruling to matters under § 329 and ordered the disgorgement of fees based on improper disclosures.

[3] Other Courts express disapproval of a two-contract approach. For example, in *Hines,* the Court criticized the idea of a two-contract system, finding such arrangement to be "patently artificial." *Hines*, 147 F.3d at 1190.

ii. Bifurcation Approved in Some Limited Circumstances

In *In re Hazlett*, 2019 Bankr. LEXIS 1166, 2019 WL 1567751 (Bankr. D. Utah Apr. 10, 2019), the attorney offered the debtor three payment options: (1) pay the attorney $2,400.00 pre-petition which included the attorney's fees and court filing fee; (2) pay the attorney $500 pre-petition for the preparation and filing of the bankruptcy petition, statement of social security number, and application to pay the court filing fees in installments and then (a) proceed *pro se*, (b) hire another attorney to complete the case, or (c) enter into a post-petition fee agreement with the attorney to complete the bankruptcy case; and (3) Pay nothing pre-petition and enter into a pre-petition retainer agreement for the preparation and filing of the initial bankruptcy papers for $0 down, with the option to either proceed *pro se*, hire another attorney, or enter into a post-petition fee agreement of $2,400 (which included fees and costs) in 10 equal monthly payments for the prosecution of the case through the entry of a discharge. The debtor selected the third option.

The Court distinguished unbundling from bifurcation of fees, defining unbundling as a situation in which the attorney is contractually limits services to a discrete tasks, such as filing the bankruptcy petition and defining bifurcation as a situation in which the attorney contracts to represent the debtor during the entire case, contingent on the debtor signing the post-petition agreement. The Court noted that the primary concern with unbundling is that the attorney provides a limited service and then leaves the client to his or her own devices to complete the legal process. It would appear that in the case of unbundling the attorney does not commit to provide post-petition services, whereas with bifurcation the attorney does make such a commitment. The Court concluded that the attorney in *Hazlett* was simply bifurcating his contracts and so it declined to address the issue of unbundling.

The Court concluded that there are four essential requirements when using bifurcated fee agreements: (1) the use of two contracts must be in the best interests of the client (*e.g.*, the client could not otherwise afford to hire bankruptcy counsel); (2) the attorney must provide appropriate disclosures, options, and explanations; (3) the client must give his or her informed consent in writing; and (4) the attorney's fee and costs must be reasonable and necessary. The Court found that the attorney had met each of these requirements.

In *In re Carr*, 613 B.R. 427 (Bankr. E.D. Ky. 2020) the attorneys received $300 from chapter 7 debtor pre-petition and were to be paid $1,185 post-petition. After the Court determined that debtor did not schedule any debt owed to the attorneys, the Court required the attorneys to file their written engagement agreement and related documents.

The Court made the following findings of fact. Under a single contract option, a Chapter 7 debtor could pay the attorneys $800.00 plus filing fees. Under a two-contract option, the debtor could pay the attorneys $300 pre-petition for pre-petition services rendered and $850.00 for post-petition services (plus $335.00 for the filing fee) to paid post-petition in 12 equal monthly payments of $98.75. The debtor had the option of continuing *pro se* or hiring another attorney for post-petition services. The Court found that the payment scheme included an

internal interest rate of 7.55%. The attorney collected the payments from the debtor's bank account. The attorney did not enter into a factoring agreement.

The Court concluded that the attorneys' representation of debtors under dual contracts satisfied the requirements in the Code, the Bankruptcy Rules, and applicable ethical rules, with the exception that the attorneys should have been more clear in their fee disclosure regarding the fact that they were proceeding under a dual contract scheme of representation.

iii. Financing Attorney's Fees

In *In re Milner*,[4] 612 B.R. 415 (Bankr. W.D.Ok. 2019) (currently on appeal), the attorney offered the debtor two payment options. One such option was a classic one-contract option where the debtor would pay the attorney $1,500.00. If the debtor could not afford to pay that amount pre-petition, then the attorney would offer a two-contract (bifurcated contract) option, one contract for pre-petition services and one contract for post-petition services. After the debtor paid the attorney $300.00 and the petition was filed, the debtor had the option of continuing *pro se*, hiring another attorney to proceed, or entering into a post-petition contract with the original attorney. Under the post-petition contract, the debtor would agree to pay $200.00 per month for twelve months.

The attorney, in order facilitate the payment and collection of the debtor's post-petition payments, entered into a Line-of-Credit Agreement ("LCA") with Fresh Start Funding ("Fresh Start"). Under the LCA, Fresh Start gave the attorney a line of credit, and the attorney submitted the post-petition contract to Fresh Start. Fresh Start would pay the attorney 60% of the $2,400.00 to the attorney. If the payments were made, the attorney would receive another 15%. In any event, Fresh Start would keep 25%, $600.00, of the $2,400.00. Further, the attorney essentially guaranteed the payments to Fresh Start.

The Court, citing *Hazlett*, held that bifurcated contracts are not prohibited by the Bankruptcy Code. The Court concluded that it was understandable that attorneys are reluctant to represent Chapter 7 debtors who cannot compensate them in full pre-petition. The conclusion was based on two facts: (1) a Chapter 7 debtor's attorney fees cannot be treated as an administrative expense (*Lamie v. U.S. Trustee*, 540 U.S. 526 (2004),) and (2) a debtor's pre-petition promise to pay attorney fees is dischargeable (citing a number of circuit opinions).

The Court adopted the *Hazlett* test to determine when a debtor's attorney may use bifurcated fee agreements in Chapter 7 and held that bifurcated contracts may be appropriate where: (1) it is in the best interests of the client; (2) the attorney provides appropriate disclosures, options, and explanations; (3) the client gives informed consent in writing; and (4) the attorney's fee and costs are reasonable and necessary.

The Court then held that the attorney did not meet the *Hazlett* requirements because it could not find that it was in the best interest of the debtor to pay the attorney $2,400.00 under the

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[4] At the time of the submission of these materials, November 13, 2020, no decision on the appeal at the District Court has been issued.

post-petition contract and because the attorney's disclosures were inadequate. Further, the Court found that the attorney's fees were unreasonable.

The Court also found that the attorney did not provide adequate disclosure of his fees and services as required under 11 U.S.C. §§ 526-528. The Court found that the compensation terms of the disclosure statement were confusing, that the disclosure of matters covered by both contracts was confusing, that the disclaimer of representation was both confusing and inappropriate, and that the fee options were also confusing.

c. **No Contract for Full Representation in the Case**

In *In re Ruiz*, 515 B.R. 362 (Bankr. M.D. Fla. 2014), the attorney agreed to represent the debtor both before and after the Chapter 7 bankruptcy case was filed but did not sign the petition, attend the meeting of creditors with the Debtor, or perform the other minimal duties required of attorneys representing debtors. The debtor filed a signed petition indicating he was not represented by counsel. The attorney did not sign the petition but did file a copy of a limited representation agreement with the Debtor. There was no agreement signed for the attorney to represent the debtor in the full bankruptcy case.

The Court framed the issue as follows: Can "an attorney provide services for consultation and preparation of the bankruptcy petition and related papers but then cause the debtor to file *pro se* without making an appearance or representing the debtor at the meeting of creditors?" *Ruiz* at 364. The Court first noted that Florida Rule of Professional Conduct 4-1.2(c) permits the unbundling of legal services if not prohibited by law or rule. The Court then inquired as whether the attorney violated Local Rule 2091-1 which provides that "[u]nless allowed to withdraw from a case ... by order of the Court ... counsel filing a petition on behalf of a debtor shall attend all hearings scheduled in the case or proceeding at which the debtor is required to attend...."

The Court next considered *In re Merriam*, 250 B.R. 724 (Bankr.D.Colo.2000) which ruled that the attorney was required to sign the petition under Bankruptcy Rule 9011:

> "When an attorney has the client sign a pleading that the attorney prepared, the attorney creates the impression that the client drafted the pleading. This violates both Rule 11 and the duty of honesty and candor to the court. . . . [t]he failure of an attorney to sign a petition he or she prepares potentially misleads the Court, the trustee and creditors, and distorts the bankruptcy process."
>
> *Merriam*, 250 B.R. at 733.

The *Merriam* Court did, however, allow the fees to stand because the attorney had adequately disclosed the limits of his representation, the debtor had chosen the more limited option, the fees were not unreasonable and there was no harm done to the debtor by the limited representation.

Ultimately, the *Ruiz* Court also cited *In re Castorena*, 270 B.R. 504 (Bankr.D.Idaho 2001), in which the Court stated:

> This Court agrees that there is no excuse for a lawyer, who counsels a debtor regarding a bankruptcy and prepares that debtor's petition, schedules and related documents, to fail to sign the petition. The attorney is responsible for what appears in such pleadings, and his signature is a required certification under Rule 9011(b)."
>
> *Castorena*, 270 B.R. at 515.

Finally, the Court distinguished the facts in *Torrens v. Hood (In re Hood*), 727 F.3d 1360 (11th Cir.2013) from those in *Ruiz*. In *Hood*, a secretary in the law firm filled out the blanks on the form petition and the debtor filed it without an attorney signature. The Eleventh Circuit held, in a very limited holding that the attorney did not violate the Florida Rules of Professional Conduct.

The *Ruiz* Court held that the attorney could not evade his responsibilities under Local Rule 9011-1 by doing all the work and then giving the debtor the papers to file falsely pretending he is acting *pro se*, and, further, that the attorney was obligated to sign, and is deemed to have filed, the petition. The *Ruiz* Court ordered the attorney to disgorge all fees and concluded by stating that "The Law Firm inconsistently agreed, on one hand, to provide full representation to the Debtor, but, on the other hand, refused to formally appear in the case, sign the petition, attend the meeting of creditors with the Debtor, or provide the normal legal services required of attorneys representing debtors in Chapter 7 bankruptcy cases." *Ruiz* at 364.

D. The Practice of Factoring and/or Financing Attorney Fees in Bifurcated Cases to Offer No Money Down or Low Money Down Chapter 7 Cases

Related to unbundling is the emerging debtors' attorneys' practice of contracting with factoring companies or finance companies to ensure the payment of attorney's fees in order to offer low or no money down Chapter 7 bankruptcies. Under the practice of factoring, the holder of accounts receivable sells them to the factor for a discounted amount, that is, an amount that is less than the face amount of the receivables. The factor then earns a profit by collecting the receivables. In the context of consumer bankruptcy cases, the debtor's attorney might sell the post-petition accounts receivables for the unbundled or bifurcated services typically contracted under a post-petition attorney fee agreement. Financing agreements work similarly, with the lender extending credit to the debtor's attorney based on the post-petition fee agreement and then in certain cases providing the collections for those post-petition fees.

The use of factoring companies and financing agreements like these, however, have come under scrutiny by certain courts and the Office of the U. S. Trustee, and complaints filed in various enforcement actions highlight some of the potential issues.[5]

[5] *See*, *e.g.*, Bloomberg Law, *Firm Sued by U.S. Trustee Over Billing Practices in Chapter 7s*, December 19, 2017, https://biglawbusiness.com/firm-sued-by-u-s-trustee-over-billing-practices-in-chapter-7s/, (referencing Adversary Proceeding No. 17-01271, filed in the case of *In re Gilmore*, pending in the U.S. Bankruptcy Court for the Central District of California), and Bloomberg Law, *U.S. Trustee Files Motion Against Lawyer's Fees in Chapter 7 Case*, February 27, 2018, https://biglawbusiness.com/us-trustee-files-motion-against-lawyers-fees-in-chapter-7-case/,

1. Potential Issues Raised by Factoring and Financing Arrangements

The practice of factoring and financing attorney fees in the consumer debtor context raises a number of issues including: (1) whether the fees arising from post-petition Chapter 7 services are dischargeable, subject to the automatic stay, and may conceal the improper collection of attorney's fees for pre-petition services; (2) whether the arrangement causes the debtor to pay higher attorney's fees than the attorney otherwise would charge or than what may be deemed reasonable; and (3) whether the financial transaction is properly disclosed in the schedules and statements filed with the petition.[6]

2. Dischargeability, Stay Implications and the Bifurcation of Services

The first issue that must be considered when a Chapter 7 attorney factors or finances receivables owed by a debtor is whether the debtor's debt to the attorney (and hence the debtor's debt to the factor in the case of factoring) is dischargeable and subject to the stay imposed in 11 U.S.C. § 362. While all courts hold any unpaid debt based on a claim for pre-petition services to be dischargeable in Chapter 7, the courts are in in some disagreement, as described previously in this paper, regarding whether an attorney can collect unpaid fees for post-petition services based on a pre-petition contract. *Compare*, e.g., *Hines*, 147 F.3d. 1185 (9th Cir. 1998), with *Bethea*, 352 F.3d 1125 (7th Cir.2003). If the unpaid fees are dischargeable, then the factoring or financing of the receivable arising from the debt does not change the analysis. The receivables would be discharged and subject to the automatic stay.

To minimize the risk of the discharge of fees, factoring and finance companies suggest to debtors' counsel a two-contract practice model.[7] The skeletal petition would be filed for low or no money down, and then the debtor would be offered the opportunity to contract, post-petition, for the services of the attorney needed to complete the case. Attorneys endorsing such a practice would note that it is not dissimilar from a *pro se* debtor that seeks out and hires competent counsel for the completion of the case and schedules after the debtor files his or her own basic petition. Under such a scenario, the fees due under the post-petition contract would not be dischargeable. *See*, Garrison, Daniel, *Liberating Debtors from "Sweatbox" and Getting Attorneys Paid, ABI Journal*, Vol. XXXVII, No. 6, June 2018, at p. 66. However, is a different analysis required when the same attorney is involved pre- and post-petition in the planning of two legal services separate contracts?

Critics might argue that the planned division of services with the only substantial fees charged post-petition is a fiction because significant legal work is required before a petition may properly be filed. Competent representation requires review of assets, income and liabilities prior to filing even a skeletal petition. Thus, is the bifurcation of the work and ultimate factoring

(referencing the Motion to Examine Fees filed in the case of *In re Neufville*, Case No. 17-24812, from the U.S. Bankruptcy Court for the District of Maryland).

[7] The complaint of the U.S. Trustee in the *In re Gilmore* case includes as an attachment a "welcome memo" from the factoring company which describes the suggested two-contract approach. *See*, p. 29 of 147 of the Complaint at Docket Entry No. 1, December 12, 2017, Adversary Proceeding No. 17-01271.

or financing of the fees arguably concealing the improper collection of attorney's fees for pre-petition services?

Of course, if any issue as to the dischargeability of the fees remains an open question in a particular jurisdiction, the attorney would need to properly inform the client. In some actions, the Office of the United States Trustee has, in fact, asserted that the attorney in these scenarios has not properly advised the debtor regarding the automatic stay or the discharge.

3. Increased Attorney's Fees and Review of Reasonableness

Another issue that arises in the factoring and financing scenarios is whether the debtor is forced to pay a higher amount in attorney's fees. If the attorney would accept the reduced amount from the factor, he or she should also accept the same reduced amount from the debtor according to the Utah State Bar Ethics Committee. *See*, Advisory Opinion No. 17-06, at ¶ 2.c., September 27, 2017. In addition to implicating ethical responsibilities, increasing attorney's fees to compensate for the factoring or financing of fees may run afoul of the reasonableness of fees requirements of 11 USC § 329(b). The fact that the attorney is willing to accept an amount that is discounted from what he is asking the debtor to pay might support the notion that the fees that the debtor is being charged are high. "If the lawyer is willing to do the work with a thirty percent discount, we question (but do not resolve) whether the total fee is reasonable." *Id.*, at ¶ 17. Of course, the other side of this coin is that the debtor could possibly pay less in a post-petition fee arrangement than he or she would pay through garnishment, which in many cases may in some jurisdictions be as much as 25% of a debtor's gross wages. *See*, *Liberating Debtors from "Sweatbox" and Getting Attorneys Paid,* at p.67.

4. Disclosure of the Financial Arrangement and Informed Consent

Clear disclosure of the bifurcation of the legal services and the factoring of the attorney's fees must be made both to the debtor and the Court. The American Bar Association's Model Rules of Professional Conduct Rule 1.2 (c) allows attorneys to limit the scope of their representations as long as the limitation is reasonable, and the client gives informed consent after full disclosure. Further, Bankruptcy Rule 2016(b) mandates disclosures for payments made "in a case under this title, or in connection with such a case."

The ABA's Model Rules of Professional Conduct 1.2(c) provides that "[a] lawyer may limit the scope of the representation if the limitation is reasonable under the circumstances and the client gives informed consent." Rule 1.0(e) then defines "informed consent," explaining that it "denotes the agreement by a person to a proposed course of conduct after the lawyer has communicated adequate information and explanation about the material risks of and reasonably available alternatives to the proposed course of conduct." Courts consider carefully the requirement of informed consent in the context of bifurcated fee arrangements, specifically questioning whether the debtor comprehends the risks associated with the withdrawal of the attorney should the post-petition payments not be completed. See e.g., *In re Grimmett*, 2017 Bankr. LEXIS 1492 (D. Idaho 2017) (affm'd on appeal). How should a debtor's attorney adequately advise the debtor of the risks of representing oneself at a meeting of creditors and completing all tasks necessary for a discharge?

In addition, bifurcating legal services under a two-contract system requires particular timing. The post-petition contract must in fact be executed after the date of the Chapter 7 filing and requires the informed consent of the debtor to the arrangement. This would likely need to include the clear disclosure to the debtor of the other options that he or she may have, including proceeding *pro se* or hiring another lawyer to complete his or her case. *See*, *Walton II*, at 386.

5. Professional Independence of the Lawyer

The Trustee's allegations and the debtor's attorney in the *In re Neufville* matter included concerns related to the use of the retainer documents, consent forms, and recurring payment forms of the third party factory company.[8] The Trustee alleged that the use of those forms of a third party by the debtor's attorney that had a financial arrangement with that third party impacted the attorney's independent professional judgment and created a conflict of interest. The Trustee's pleading cites the Maryland Rules of Professional Conduct that correspond to the following ABA Model Rules of Professional Conduct:

> Rule 5.4(c): Professional Independence of a Lawyer. (c) A lawyer shall not permit a person who recommends, employs, or pays the lawyer to render legal services for another to direct or regulate the lawyer's professional judgment in rendering such legal services.
>
> Rule 1.8(f): Current Clients: Specific Rules. (f) A lawyer shall not accept compensation for representing a client from one other than the client unless:
> (1) the client gives informed consent;
> (2) there is no interference with the lawyer's independence of professional judgment or with the client-lawyer relationship; and
> (3) information relating to representation of a client is protected as required by Rule 1.6.
>
> Rule 1.7(a): Conflict of Interest: Current Clients. (a) Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a concurrent conflict of interest. A concurrent conflict of interest exists if:
> (1) the representation of one client will be directly adverse to another client; or
> (2) there is a significant risk that the representation of one or more clients will be materially limited by the

[8] Ultimately the *In re Neufville* matter was resolved by the entry of a consent order entered 4/12/19 cancelling the fee agreements between the debtor and the debtor's attorney and providing for the disgorgement of certain fees. *In re Neufville*, Case No. 17-24812, Docket Entry No. 104, April 12, 2019, U.S. Bankruptcy Court for the District of Maryland.

> lawyer's responsibilities to another client, a former client or a third person or by a personal interest of the lawyer.

V. Conclusion

As with many thorny issues in the practice of bankruptcy, different approaches are developing that seek to accomplish the same goal: the payment of reasonable attorney's fees by debtors in an affordable and appropriate manner so that debtors may have access to the relief they need and also the benefit of competent legal advices during their cases. Case law is rapidly developing in this area that provides some guidance to practitioners, and the topic continues to be an active one in academic and professional publications. Particularly in the absence of statutory changes such as those recommended by the Consumer Commission, counsel must be mindful of all the relevant issues and ethical considerations as they establish procedures in their own firms for charging and handling attorney fees consumer debtor cases.