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THE GOOD, THE BAD, THE UNETHICAL: CURRENT ISSUES IN BANKRUPTCY ETHICS

I. THE EMPLOYMENT OF PROFESSIONALS

A. Who is a "Professional?"

Section 327(a)[1] allows a trustee "with the court's approval" to employ "one or more attorneys, accountants, appraisers, auctioneers, *or other professional persons* . . . to represent or assist the trustee in carrying out the trustee's duties under this title." (emphasis added). Whether a person is deemed a "professional" is highly significant to determining whether that person may be compensated from estate funds. If the person is a professional, then he must obtain a court order authorizing his employment. Failure to do so may result in denial of compensation and even disgorgement of funds received. "Non-professionals," on the other hand, may be employed and paid from the estate in the ordinary course of the debtor's business, without court order. 11 U.S.C. § 363(c)(1). "Non-professionals" are not subjected to § 327(a)'s requirements that they hold no interest adverse to the estate and are "disinterested." 11 U.S.C. § 327(a).

The statute's catch-all phrase "other professionals" is undefined and sufficiently vague. It has engendered a great deal of debate and disagreement over how inclusively or exclusively it should be interpreted. On one end of the spectrum, we know that attorneys, accountants, appraisers, and auctioneers are clearly professionals. On the other end of the spectrum, most would agree that bookkeepers who perform only ministerial tasks and do not work on matters of estate administration would not be considered professionals. In a perfect world, debtor's counsel would file an employment application for every person who falls into the "gray area" in the middle so that we would not run into situations in which someone is deemed to be a professional after the fact and denied compensation. All too often, however, we do not live in a perfect world and the court is forced to decide how "professional" the "professional" really is.

There are several tests employed by courts to answer this question. None of these tests are wholly satisfactory. Cases representative of these different views are:

1. The definition of a "professional" is limited to "an individual who takes a central role in the administration of the debtor's bankruptcy estate and bankruptcy proceedings, as opposed to one who provides services to the debtor that are necessary regardless of whether a bankruptcy petition was filed." *In re Seatrain Lines, Inc*. 13 B.R. 980, 981 (Bankr. S.D.N.Y. 1981). This is sometimes referred to as the "quantitative analysis." It is "limited to those

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occupations which play a central role in the administration of the debtor proceeding, and not those occupations which are involved in the day-to-day mechanics of the debtor's business." *In re First Merchants Acceptance Corp.*, 1997 WL 873551, at *2 (D. Del. Dec. 15, 1997).

2. By way of contrast, the "qualitative analysis" focuses on the amount of "discretion" or "autonomy" allowed to the person performing some part of the administration of the bankruptcy proceeding. *Id.* (citing *In re Fretheim*, 102 B.R. 298, 299 (Bankr. D. Conn. 1989)).

3. Some courts combine these two tests and apply a multi-factor analysis:

> (1)whether the employee controls manages, administers, invests, purchases or sells assets that are significant to the debtor's reorganization; (2) whether the employee is involved in negotiation of the terms of a Plan of Reorganization; (3) whether the employment is directly related to the type of work carried out by the debtor or to the routine maintenance of the debtor's business operations; (4) whether the employee is given discretion or autonomy to exercise his or her own professional judgment in some part of the administration of the debtor's estate; (5) the extent of the employee's involvement in the administration of the debtor's estate; and (6) whether the employee's services involve some degree of special knowledge or skill, such that the employee can be considered a "professional" within the ordinary meaning of the term.

In re First Merchants Acceptance Corp., 1997 WL 873551, at *3.

4. Some courts criticize these tests for focusing only on the second part of § 327(a): "to represent or assist the trustee in carrying out the trustee's duties. . . ." These tests focus on whether the person's duties are tied to the administration of the case or only the debtor's day-to-day business and whether their duties afford them discretion or autonomy, but they fail to also give meaning to the first requirement of the statute that the person must be a "professional."

> "[P]rofession" is generally defined as:
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> A vocation or occupation requiring special, usually advanced, education and skill....
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> The labor and skill involved in a profession is predominantly mental or intellectual, rather than physical or manual.
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> The term originally contemplated only theology, law and medicine, but as applications of science and learning are extended to other departments of affairs, other vocations also receive the name, which implies professed attainments in special knowledge as distinguished from mere skill.
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> *Black's Law Dictionary* 1089–90 (5th ed. 1979). . . . Thus, a professional should be considered someone with *a special knowledge and skill usually achieved by study and educational attainments whether licensed or not*.

In re Metro. Hosp., 119 B.R. 910, 916 (Bankr. E.D. Pa. 1990) (emphasis added).

5. One court limited the scope to fit the underlying purpose of § 327(a) to prevent cronyism.

> The legislative history makes clear that the 1978 Code was designed to eliminate the abuses and detrimental practices that had been found to prevail [under the Bankruptcy Act of 1898]. Among such practices was the cronyism of the "bankruptcy ring" and attorney control of bankruptcy cases. In fact, the House Report noted that "[i]n practice ... the bankruptcy system operates more for the benefit of attorneys than for the benefit of creditors." H.R. No. 595, 95th Cong., 2d Sess. 92, reprinted in 1978 U.S. Code Cong. & Ad. News 5787, 5963, 6053.

In re CNH, Inc., 304 B.R. 177, 180 (Bankr. M.D. Pa. 2004). If preventing cronyism is the reason for requiring court approval, then, according to this court, the interpretation of "professional" should be limited to those "linked with the legal and financial administration of the bankruptcy [who] have been severely scrutinized by reason of their pivotal impact on the course of the case and a perceived history of abuse." *Id.* at 181. Applying this test, the court found an independent contractor who developed and implemented new nursing policies at the debtor's nursing home was not a professional, even though many courts would construe a "turnaround management consultant" as a professional. This expert on standards of care for nursing homes was not a part of the "bankruptcy ring" or "hangers-on" around bankruptcy cases that would have been a benefactor of cronyism.

The following list shows the rulings courts have made in regard to the following positions:

A. Person is a § 327(a) Professional:

1. *Cushman & Wakefield of Conn., Inc. v. Keren Ltd. P'ship (In re Keren Ltd. P'ship)*, 189 F.3d 86 (2d. Cir. 1999). Personal property brokerage firm was a professional.

2. *DOLA Int'l Corp. v. Bordlemay (In re DOLA Int'l Corp.)*, 88 B.R. 950 (Bankr. D. Minn. 1988) Management consulting firm specializing in troubled companies was a professional.

3. *In re First Sec. Mortg. Co*., 117 B.R. 1001 (Bankr. N.D. Okla. 1990*).* Staffing agency hired to find a "loan closer" was a professional. Court actually expressed some doubt about this conclusion, but said it would retroactively approve the headhunter's employment, so it could be compensated under § 330.

4. *Bicostal Corp. v. Clear (In re Bicoastal Corp.)*, 149 B.R. 216 (Bankr. M.D. Fla. 1993). Investment advisor hired to administer the estate's pension plans was a professional.

5. *In re Neidig Corp.*, 117 B.R. 625 (Bankr. D. Colo. 1990). Manager in charge of debtor's business operation was a professional.

6. *In re ACandS, Inc*., 297 B.R. 395 (Bankr. D. Del. 2003). Processor of asbestos claims making frontline decisions about allowance of claims is professional.

7. *In re Metro. Hosp*., 119 B.R. 910 (Bankr. E.D. Pa. 1990). Collection agency was a professional when its services went "far beyond mere debt collection" to include determinations regarding hospital patients' eligibility for Medicaid, as well as the filing of Medicaid reimbursement claims.

8. *In re New Orleans Auction Galleries, Inc*., 2013 WL 1196680 (Bankr. E.D. La. Mar. 25, 2013). Public relations firm was a professional. (Contra case at #5 below).

B. Person is Not a § 327(a) Professional:

1. *Comm. of Asbestos-Related Litigants v. Johns-Manville Corp. (In re Johns-Manville Corp*.), 60 B.R. 612 (Bankr. S.D.N.Y. 1986). Lobbyists retained by debtor in the ordinary course of business were not 327(a) professionals. A distinction should be made between persons who are merely involved in the mechanics of the debtor's business operations and those who actually affect the administration of the debtor's reorganization. The term "other professional persons" in section 327(a) "is quite obviously not intended to cover without limitation all those persons of education, ability and accomplishment in any calling who may be regarded as professionals based upon considerations of societal, governmental or academic accreditation, or their own self-esteem . . . . Persons with such a tangential relationship to the . . . estate do not fall within the rubric of 'professional persons' under 327(a)."

2. *In re Seatrain Lines, Inc*., 13 B.R. 980 (Bankr. S.D.N.Y. 1981). Maritime engineers hired as consultants to debtor's business were not professionals.

3. *Windsor Commc'ns Group, Inc. v. Rogers & Rogers, Inc. (In re Windsor Commc'ns Group, Inc.)*, 68 B.R. 1007 (E.D. Pa. 1986). In general, collection agency is not a professional.

4. *In re Found. Group Sys., Inc*., 141 B.R. 196 (Bankr. E.D. Cal. 1992). Unlicensed and unregulated finders (of funding sources) were not professionals.

5. *In re Seven Cty. Servs., Inc.*, 496 B.R. 852 (W.D. Ky. 2013). Public relations firm is not a professional.

6. *In re Am. Tissue, Inc.*, 331 B.R. 169 (Bankr. D. Del. 2005). Company that specialized in monitoring antitrust class actions on behalf of class members and processing their claims is not a professional.

7. *U.S. Trustee v. McQuaide (In re CNH, Inc.)*, 304 B.R. 177 (Bankr. M.D. Pa. 2004). Consultants developing nursing practices and protocol for debtor nursing home are not professionals.

8. *Butler v. Indiano, Williams & Weinstein (In re Ponce Marine Farm, Inc.)*, 259 B.R. 484 (D.P.R. 2001). Wetland expert, retained to serve as expert witness, and professional photographer, hired to take photos of debtor's property were not professionals

9. *In re Sieling Assocs. Ltd. P'ship*, 128 B.R. 721 (Bankr. E.D. Va. 1991). Environmental toxicologist retained to provide expert testimony is not a professional.

10. *In re Century Inv. Fund VII Ltd P'ship*, 96 B.R. 884 (Bankr. E.D. Wis. 1989). Property manager for debtor's business complex is not a professional.

11. *In re Park Ave. Partners Ltd. P'ship*, 95 B.R. 605 (Bankr. E.D. Wis. 1988). Property manager is not a professional because not sufficient autonomy and discretion.

12. *In re ITG Vegas, Inc.*, 2007 WL 1087212 (Bankr. S.D. Fla. Apr. 3, 2007). Lobbyist not a professional.

13. *In re Mason's Nursing Ctr, Inc*., 73 B.R. 360 (Bankr. S.D. Fla. 1987). Entity that was not licensed to act as real estate broker, but who was hired to sell debtor's primary asset was not a professional.

14. *In re Cyrus II P'ship*, 2008 WL 3003824 (Bankr. S.D. Tex. July 31, 2008). Expert witness not testifying on matter central to the administration of the estate is not a professional.

15. *In re Artra Group, Inc*., 308 B.R. 858 (Bankr. N.D. Ill. 2003). Expert witness hired for lawsuit commenced pre-petition is not a professional.

16. *In re Fretheim*, 102 B.R. 298 (Bankr. D. Conn. 1989). Surveyor hired by special counsel for debtor to perform land survey of property of the estate in preparation for sale is not a professional.

17. *In re Renaissance Residential of Countryside, LLC*, 423 B.R. 848 (Bankr. N.D. Ill. 2010) ("*Renaissance Residential*"). Person who performed both accounting and bookkeeping services was not a "professional" to the extent of the bookkeeping services. Bookkeeping fees were allowed but fees incurred in preparation of bankruptcy schedules, preparation for the § 341 meeting, attendance at the § 341 meeting, creation of exhibits, analysis of evidence, drafting of legal documents, and discussions with witnesses and the debtor about the case were deemed "professional" in nature and, due to the failure to seek court approval of the employment, the fees were denied. *Id.* at 860-61.

B. *Nunc Pro Tunc* Approval of Employment Applications

In the haste to file a chapter 11 case and in the aftermath of negotiations and emergency hearings, counsel may neglect to file employment applications for itself and other professionals required to be employed under § 327 of the Bankruptcy Code.[2] A chapter 7 trustee's counsel

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may be guilty of the same neglect. Or perhaps it was not clear at the outset but, with the benefit of hindsight, counsel now realizes that the person employed by the estate is a "professional" and § 327 employment is necessary. In each of these instances, counsel will seek to obtain *post facto* employment or *nunc pro tunc* approval to the date the professional began performing services. This section explores when and under what circumstances courts will grant retroactive approval.

Eleven circuits have weighed in on what standard should be applied to these retroactive requests. Courts within nine of the circuits have set the bar high, adopting an "extraordinary circumstances" test. *See, e.g.*, *In re Jarvis*, 53 F.3d 416 (1st Cir. 1995); *In re Tacason*, 2014 WL 7411720 (Bankr. D.N.H. 2014 Dec. 31, 2014); *Cushman & Wakefield of Conn., Inc. v. Keren Ltd. P'ship (In re Keren Ltd. P'ship)*, 189 F.3d 86 (2d Cir. 1999); *In re Ark. Co., Inc.*, 798 F.2d 645 (3d Cir. 1986); *In re Freehold Music Ctr.*, 49 B.R. 293 (Bankr. D. N.J. 1985); *In re Bible Deliverance Evangelistic Church*, 39 B.R. 768 (Bankr. E.D. Pa. 1984); *Kohout v. U.S. Trustee*, 513 B.R. 675 (N.D. W. Va. 2014); *Fanelli v. Hensley (In re Triangle Chems., Inc.)*, 697 F.2d 1280 (5th Cir. 1983); *In re Lyons*, 439 B.R. 401 (Bankr. S.D. Tex. 2006); *In re Aultman Enters.*, 264 B.R. 485 (E.D. Tenn. 2001); *Frank v. Pica Sys., Inc. (In re Pica Sys., Inc.)*, 124 B.R. 30 (E.D. Mich. 1991); *In re Twinton Props. P'ship*, 27 B.R. 817 (Bankr. M.D. Tenn. 1983); *Merchants & Farmers Bank of Dumas, Ark. v. Hill*, 122 B.R. 539 (E.D. Ark. 1990); *Atkins v. Wain, Samuel & Co. (In re Atkins)*, 69 F.3d 970 (9th Cir. 1995); *Law Office of Ivan W. Halperin v. Occidental Fin. Group, Inc. (In re Occidental Fin. Group, Inc.)*, 40 F.3d 1059 (9th Cir. 1994); *Okamoto v. THC Fin. Corp. (In re THC Financial Corp.)*, 837 F.2d 389 (9th Cir. 1988); *Lasso v. Bank (In re Schupbach Inv., LLC)*, 808 F.3d 1215 (10th Cir. 2015); *Land v. First Nat'l Bank of Alamosa (In re Land)*, 943 F.2d 1265 (10th Cir. 1991).

In two circuits, the courts have lowered the threshold to an "excusable neglect" standard. *See, e.g.*, *In re Singson*, 41 F.3d 316 (7th Cir. 1994); *In re Hall*, 373 B.R. 788 (Bankr. S.D. Ga. 2006); *In re Glover*, 2003 WL 23811474 (Bankr. S.D. Ga. June 13, 2003). The minority view recognizes that, while § 327(a) authorizes a trustee to employ professionals "with the court's approval," it does not expressly require "prior" approval. *In re Singson*, 41 F.3d at 319. Neither does Federal Rule of Bankruptcy Procedure 2014(a). On the other hand, Federal Rule of Bankruptcy Procedure 9006(b)(1) "permit[s] a party or counsel to take a step, after the time for doing so has expired, 'where the failure to act was the result of excusable neglect.' Rule 9006(b)(2) says that the court may not enlarge the time specified by seven particular rules; Rule 2014(a) is not on the list." *Id.* Even the Seventh Circuit, however, recognizes that "[p]rior approval is strongly preferred because it permits close supervision of the administration of an estate, wards off 'volunteers' attracted to the kitty, and avoids duplication of effort." *Id.* (citations omitted).

In *Lazzo v. Bank (In re Schupbach Inv., LLC)*, 808 F.3d 1215, 1219 (10th Cir. 2015), the Tenth Circuit acknowledged that the statute and the rule do not expressly require "prior" approval, but that "courts have generally read such a requirement into the statute as a matter of judicial administration." With this assumption, the majority of courts have adopted the "extraordinary circumstances test, which is perhaps best set forth in the Third Circuit's decision in *In re Arkansas Co., Inc.*, 798 F.2d 645 (3d Cir. 1986).

> To summarize, we hold that retroactive approval of appointment of a professional may be granted by the bankruptcy court in its discretion but that it should grant such approval only under extraordinary circumstances. Such circumstances do not include the mere neglect of the professional who was in a position to file a timely application. When considering an application, the bankruptcy court may grant retroactive approval only if it finds, after a hearing, that it would have granted prior approval, which entails a determination that the applicant satisfied the statutory requirements of 11 U.S.C. §§ 327(a) and 1103(a) that the applicant be disinterested and not have an adverse interest, and that the services performed were necessary under the circumstances. Thereafter, in exercising its discretion, the bankruptcy court must consider whether the particular circumstances in the case adequately excuse the failure to have sought prior approval. This will require consideration of factors such as whether the applicant or some other person bore repsonsibility [sic] for applying for approval; whether the applicant was under time pressure to begin service without approval; the amount of delay after the applicant learned that initial approval had not been granted; the extent to which compensation to the applicant will prejudice innocent third parties; and other relevant factors.

Id. at 650.

Many courts employing the majority approach have adopted the nine-part test set forth in *In re Twinton Properties Partnership*, 27 B.R. 817, 819-20 (Bankr. M.D. Tenn. 1983):

> 1. The debtor, trustee or committee expressly contracted with the professional person to perform the services which were thereafter rendered;
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> 2. The party for whom the work was performed approves the entry of the *nunc pro tunc* order;
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> 3. The applicant has provided notice of the application to creditors and parties in interest and has provided an opportunity for filing objections;
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> 4. No creditor or party in interest offers reasonable objection to the entry of the *nunc pro tunc* order;
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> 5. The professional satisfied all the criteria for employment pursuant to 11 U.S.C.A. § 327 (West 1979) and Rule 215 of the Federal Rules of Bankruptcy Procedure at or before the time services were actually commenced and remained qualified during the period for which services were provided;
>
> 6. The work was performed properly, efficiently, and to a high standard of quality;
>
> 7. No actual or potential prejudice will inure to the estate or other parties in interest;

> 8. The applicant's failure to seek pre-employment approval is satisfactorily explained; and
>
> 9. The applicant exhibits no pattern of inattention or negligence in soliciting judicial approval for the employment of professionals.

See, e.g., *Atkins v. Wain, Samuel & Co. (In re Atkins)*, 69 F.3d 970, 974 (9th Cir. 1995) (adopting *Twinton* test). The burden is on the party who seeks retroactive approval to demonstrate these factors by clear and convincing evidence. *In re Twinton Prop. P'ship*, 27 B.R. at 819. However, not every factor must be satisfied. *In re Atkins*, 69 F.3d at 975. The two essential findings are that "the applicant can show both a satisfactory explanation for the failure to receive prior judicial approval and that he or she has benefited the bankrupt estate in some significant manner." *Id.*

While there is a fair amount of jousting between the majority and the minority views as to the proper standard, there appears to be very little difference between these standards in practical application. Whether it is called "extraordinary circumstances" or "excusable neglect," all of the circuit decisions agree that an attorney's mere oversight fails to satisfy the standard. All would agree that the bankruptcy court has discretion to grant retroactive approval. An emergency need for the professional to begin services or the reliance of a professional on the statements of the debtor's counsel that it will take care of the necessary application process on behalf of the professional would suffice to meet either standard. All courts agree that prior approval is important to the integrity of the bankruptcy system and is the rule, not the exception. Thus, the differences in the standards amount to little more than a tempest in a teapot.

C. May the trustee hire her own firm?

The Bankruptcy Code does not prohibit a trustee from hiring her own firm, but requires a special showing that the employment is in the "best interests of the estate." 11 U.S.C. § 327(d). The trustee's own firm must of course meet the requirements of § 327(a) that the firm is "disinterested" and does not "hold or represent an interest adverse to the estate." 11 U.S.C. § 327(a). Assuming these two qualifications are met, what added criteria are required for the trustee to hire himself to act as an attorney for the estate, and by extension, to hire his own firm?

To understand the "best interests" requirement, it is necessary to understand the underlying concerns and hesitancy behind allowing a trustee to hire her own firm. Judge Friendly summed up these concerns well:

> The reasons are plain enough. The conduct of bankruptcy proceedings not only should be right but must seem right. Even when litigation is likely to be the trustee's chief responsibility, there must always be doubt whether he can make a truly disinterested determination that his own firm, no matter what its overall merit, is best qualified to be his counsel in the circumstances of the particular case. . . . Some creditors may doubt, as here, whether a trustee is able to take quite the same objective and critical attitude toward the amount and quality of effort being put forward by his own law firm that he would toward another. On the other

> hand, in contrast to the situation in this case, there may be instances where creditors would believe the relationship had caused a trustee to be overly litigious. Finally, even the most experienced attorney who becomes a trustee in a complicated bankruptcy can benefit from the advice of an independent general counsel; we need not go so far as the familiar adage concerning self-representation by a lawyer to say that a second head is not without value in such matters simply because the first is exceedingly good.

Knapp v. Seligson (In re Ira Haupt & Co.), 361 F.2d 164, 168-69 (2d Cir. 1966); *accord SEC v. Kenneth Bove & Co., Inc.*, 451 F. Supp. 355, 358 (S.D.N.Y. 1978).

These concerns boil down to two fundamental issues: an appearance of impropriety and a lessening of independent judgment. The appearance of impropriety stems from an appearance of "cronyism." "Stated differently, the Trustee has a fiduciary duty to bring in funds, not friends." *In re Bechuck*, 472 B.R. 371, 377 (Bankr. S.D. Tex. 2012). As stated in the previous section, legislative history makes clear that the 1978 Code was designed to eliminate cronyism of the 'bankruptcy ring.' *In re Ark. Co., Inc.*, 798 F.2d 645, 649 (3d Cir. 1986).

Granted, cronyism may be just as prevalent when the trustee repeatedly hires the same two or three outside firms. But the creditors in a given case are less likely to be aware of this fact. They will, however, notice that the trustee has hired his own firm. As a result, the employment may serve to erode creditor confidence. The creditors may see large fee applications filed by the trustee's firm and question whether the trustee will give these applications the same scrutiny he would give to those of an outside firm. Or the trustee may appear impassive when creditors question whether he should rein in the litigation partners of his firm, who appear more willing to litigate than to find more cost-effective ways to resolve disputes. Creditors may wonder if the trustee is "double dipping" by billing certain tasks as an "attorney" when he might otherwise perform the same task as one of the administrative functions of his job as a trustee.

The other concern is that the trustee might receive less candid and independent advice from inside counsel. Will a partner or associate in the trustee's own firm be comfortable questioning the trustee's strategies and assessments? On the other hand, will the trustee feel free to question his firm's advice, especially if he is represented by a family member in his own firm, which happens not infrequently in small firms?

Undoubtedly, there are benefits to be gained by hiring one's own firm. There is a sort of shorthand in communication developed between members of a firm who work together often. And the trustee merely walks down the hall to find his counsel instead of laboring to set a conference call or meeting. But are these types of benefits sufficient to overcome the concerns of cronyism?

Since the Code does not impose a *per se* prohibition, courts have struggled to define what the "best interests of the estate" means in this context. Two of the most frequently cited cases on this issue offer very different multi-factor tests. In *In re Butler Indus., Inc.*, 101 B.R. 194

(Bankr. C.D. Cal. 1989), *aff'd*, 114 B.R. 695 (C.D. Cal. 1990), the court weighed the following factors:

> (1) "where the estate's assets consist principally in causes of action, such as for preferences and fraudulent conveyances, and legal counsel would have to look to the recovery for payment of fees;" (2) "where there is relatively little legal work to perform, which does not merit the effort and expense of hiring an outside law firm;" (3) "where substantial legal action must be taken immediately, and the trustee cannot wait for the completion of the appointment process for outside counsel;" and (4) "where the trustee can demonstrate that such appointment will result in a substantial reduction of costs to the estate."

Spencer D. Solomon, *Keeping Things In-House: Increasing Scrutiny of the Chapter 7 Trustee's Selection of Counsel*, 55 S. Tex. L. Rev. 665, 679 (Summer 2014) (summarizing the *Butler* decision).

In *In re Interamericas, Ltd.*, 321 B.R. 830, 834 (Bankr. S.D. Tex. 2005), the court employed the following nine-factor test:

> (1) The qualifications of the members of the firm compared to the complexity of the case; (2) Whether the firm is regularly hired by others to handle similar litigation; (3) Whether the anticipated litigation predominantly involves issues of bankruptcy law with which the law firm has particularized expertise; (4) Whether the time commitment required to handle the case is consistent with the size of the firm and the balance of the firm's time commitments; (5) Whether only a nominal amount of work must be performed; (6) The availability of other qualified firms to handle the case; (7) The rates charged by the firm compared to the rates charged by other qualified firms; (8) Whether there will be material cost savings to the estate; and (9) Other case-specific factors.

Solomon, *Keeping Things In-House*, *supra*, at 683.

The *Interamericas* test focuses too heavily on the qualifications and expertise of the trustee's firm and whether the size and composition of the firm is a good fit for the case. These are important factors to consider in hiring any firm, but they do not help to answer the question of when a trustee should be allowed to hire his own firm, instead of another equally well-suited firm that will not raise concerns of cronyism. The *Butler* test, on the other hand, narrows the circumstances of when a trustee may hire his own firm and attempts to identify the benefits that an estate may realize by doing so.

II. COUNSEL'S DUTY OF REASONABLE INVESTIGATION

A. Comparisons Between Rule 9011, § 526(a)(2) and § 707(b)(4)(C) & (D)

Prior to BAPCPA, the means already existed for imposing sanctions on counsel (and parties) who presented a "petition, pleading, written motion, or other paper" (collectively, a

"Document") to the court (whether by signing, filing, submitting, or later advocating) without performing "*an inquiry reasonable under the circumstances*" into whether the statements in the Document are well founded in law and fact and submitted for a proper purpose. Fed. R. Bankr. P. 9011(b) ("Rule 9011"). We all know Rule 9011 and its requirements well. It specifies the procedures for obtaining sanctions for a violation, which include a requirement that the moving party give prior warning of the alleged violation and a 21-day period for the violator to retract the offending Document. *Id.* at (c)(1)(A). If the Document is not retracted during the safe harbor and a motion is filed, then the court *may* award the prevailing party its reasonable expenses and attorney's fees related to either prosecuting *or defending* the sanctions motion. This rule also gives express permission to the court to act on a *sua sponte* basis to impose sanctions. *Id.* at (c)(1)(B).

Sanctions under this rule should be "limited to what is sufficient to deter repetition of such conduct or comparable conduct by others similarly situated." *Id.* at (c)(2). It may involve "directives of a non-monetary nature" (attendance at the equivalent of bankruptcy traffic school?), an order to pay a penalty to the court, or "*if* imposed on motion and *warranted for effective deterrence*, an order directing payment *to the movant* of *some or all* of the reasonable attorneys' fees and other expenses incurred *as a direct result* of the violation." *Id.* (emphasis added). This rule is not intended to be a shot gun fee-shifting provision, but a targeted rifle shot aimed at the costs added by the offending Document or advocated position.

Rule 9011 is even handed. It allows the court to sanction violations in consumer and commercial cases alike. It permits sanctions to be leveled against both debtor and creditor counsel. It is also broad in its scope in that it is not limited to certain types of Documents filed in a bankruptcy case.

Given the existence of this broad and even-handed rule, why did Congress believe it was necessary to add three new provisions in BAPCPA for imposing sanctions against debtor's counsel in consumer cases for untrue or misleading statements in Documents?

> Historically, there has been some question whether bankruptcy schedules and SOFAs fell within the scope of Rule 9011 sanctions. . . . *See In re Trudell*, 424 B.R. 786, 791 (Bankr. W.D. Mich. 2010); 10 COLLIER ON BANKRUPTCY ¶ 707.05[2] (Alan N. Resnick & Henry J. Sommer, 16th ed. 2010); *cf. Caldwell v. Unified Capital Corp. (In re Rainbow Magazine, Inc.)*, 77 F.3d 278, 283 (9th Cir. 1996)(concealing asset in SOFA is a false statement sanctionable under Rule 9011). This question, however, appears to have been definitively settled by Congress' enactment of the comprehensive amendments to the Code in 2005, commonly known as BAPCPA.

Orton v. Hoffman (In re Kayne), 453 B.R. 372, 381 (9th Cir. BAP 2011). The source of the confusion appears in Rule 9011(a) itself, where on one hand it provides that every "paper" presented to the court falls within the rule's ambit, but on the other hand sets forth an exception for "a list, schedule, or statement, or amendments thereto . . . ." Fed. R. Bankr. P. 9011(a).

These new provisions close any gap that existed, but that still does not explain why they are targeted only at debtor's counsel in consumer cases. Undoubtedly, those proposing or drafting the new provisions must have held a perception that consumer debtor attorneys were not investing the time to ensure completeness and accuracy in the schedules and related filings. "Debtor mills," like puppy mills, have become commonplace in many parts of the country. High volume, low fee consumer firms apparently do not breed confidence in the accuracy of the filings.

For whatever the reasons, Congress added § 526 to impose duties and restrictions on "debt relief agencies." 11 U.S.C. § 526. The definition of a "debt relief agency" includes "any person who provides any bankruptcy assistance to an assisted person in return for . . . valuable consideration . . . ." 11 U.S.C. § 101(12A). The Supreme Court has ruled that this definition encompasses debtor's counsel. *Milavetz, Gallop & Milavetz, P.A. v. United States*, 559 U.S. 229, 237-38 (2010). The definition of an "assisted person" limits the class of debtors within § 526's scope to "any person whose debts consist primarily of consumer debts and the value of whose nonexempt property is less than $186,825." 11 U.S.C. § 101(3). This covers the vast majority of chapter 7 and chapter 13 filings.

Section 526(a)(2) prohibits debtor's counsel (and other debt relief agencies) from making "*any statement*, or counsel[ing] *or advis[ing]* any assisted person or prospective assisted person *to make a statement in a document filed* in a case or proceeding under this title, *that is untrue or misleading, or that upon the exercise of reasonable care, should have been known* by such agency *to be untrue or misleading* . . . ." 11 U.S.C. § 526(a)(2) (emphasis added). A violation of this section, however, entitles *the debtor*, as opposed to the opposing party or the court, to recover "fees and charges," "actual damages," "reasonable attorneys' fees and costs" for the debt relief agency's intentional or negligent failure to comply with this statute. 11 U.S.C. § 526(c)(2). A state agency, the U.S. trustee, or the debtor may also bring an action to enjoin the violator and to recover fees, costs, and penalties. 11 U.S.C. § 526(c)(3), (c)(5).

Likewise § 707(b)(4)(D), added in BAPCPA, provided that the "signature of an attorney on the petition shall constitute a certification that the attorney has *no knowledge after an inquiry* that the information *in the schedules* filed with such petition is incorrect." 11 U.S.C. § 707(b)(4)(D) (emphasis added). Since this provision is limited to statements in the schedules, it will apply only to debtor's counsel, except possibly in the rare occasion of a creditor's submission of schedules in connection with an involuntary filing.

Section 707(b)(4)(C) is broader. This BAPCPA addition mirrors Rule 11 in its scope.

> The signature of an attorney on a petition, pleading, or written motion shall constitute a certification that the attorney has –
>
> *(i)Performed a reasonable investigation* into the circumstances that gave rise to the petition, pleading, or written motion; and
>
> (ii) Determined that the petition, pleading, or written motion –

(I) is well grounded in fact; and

(II) is warranted by existing law or a good faith argument for the extension, modification, or reversal of existing law and does not constitute an abuse . . . .

11 U.S.C. § 707(b)(4)(C) (emphasis added). It omits Rule 11's phrase "or other paper" but otherwise appears to apply to all Documents, not just the petition and schedules.

Is this section limited in its application to debtor's counsel? Read in a vacuum, it would appear a creditor's attorney who files a written motion ungrounded in law or fact would be covered by this provision as well. But the statute's context may indicate otherwise. Subsection 707(b)(4)(A) allows a trustee to recover its costs of prosecuting a § 707(b) motion to dismiss from debtor's counsel if, among other things, counsel's filing of a chapter 7 case violated Rule 11, presumably because it should have known the filing would be challenged as an abuse of chapter 7. Subsection 707(b)(4)(B) adds that, if debtor's counsel violated Rule 11, then the court may order counsel to pay "an appropriate civil penalty" to the trustee or U.S. trustee. 11 U.S.C. § 707(b)(4)(B). In context, subsections (C) and (D) may be limited to the debtor's filing of an inaccurate or incomplete chapter 7 filing package or the frivolous defense of a § 707(b) motion to dismiss. The following subsection, § 707(b)(5)(A), lends support to this interpretation because it provides an opportunity for a debtor to recover costs and fees if she prevails on the motion to dismiss and the motion violated Rule 11. The debtor may not recover, however, from a trustee, the U.S. trustee, or a "small business." 11 U.S.C. § 707(b)(5)(B) and (C).

B. The Contours of a Reasonable Inquiry Standard

The standards in Rule 9011 and the new BAPCPA counterparts appear to be strikingly similar. Rule 9011 imposes a duty of "an inquiry reasonable under the circumstances." Section 526(a)(2) requires the "exercise of reasonable care" to avoid an untrue or misleading statement in a Document. Section 707(b)(4)(D) requires the attorney to certify that he has "no knowledge after an inquiry" that the schedules are inaccurate. And § 707(b)(4)(C) requires the attorney signing a Document to "perform[] a reasonable investigation into the circumstances that gave rise to" the Document. 11 U.S.C. § 707(b)(4)(C). All of these appear to boil down to a duty of "reasonable inquiry."

A review of the published decisions on §§ 526(a)(2) and 707(b)(4)(C) and (D) reveal some general, non-controversial principles regarding this standard. First, the courts recognize that the standard is essentially the same as that imposed by Rule 9011 and, therefore, cases construing Rule 9011 are instructive. *See, e.g.*, *Dignity Health v. Seare (In re Seare)*, 493 B.R. 158, 209 (Bankr. D. Nev. 2013). Second, it is an objective standard. The "trial court must measure the attorney's conduct 'objectively against a reasonableness standard, which consists of a competent attorney admitted to practice before the involved court.'" *Orton v. Hoffman (In re Kayne)*, 453 B.R. 372, 382 (9th Cir. BAP 2011) (citations omitted). A debtor's attorney is required "to do more than simply take the information provided by a debtor at face value." Anne E. Wells, *Navigating Ethical Minefields on the Bankruptcy Bandwagon*, 31 Cal. Bankr. J. 767, 775 (2011). The emergency nature of a bankruptcy filing will not excuse counsel from these

responsibilities. *Id.* at 776. On the other hand, the attorney's certification "is not an absolute guaranty of accuracy . . . ." *Lafayette v. Collins (In re Withrow)*, 405 B.R. 505, 512 (1st Cir. BAP 2009). Courts must inquire as to "whether 'a reasonable attorney in like circumstances could believe his actions to be factually and legally justified.'" *Id.* (citations omitted).

These general principles do little to flesh out the nature of the duty. Their application to particular cases puts more meat on the bones. For example:

1. Attorney filed a Rebuttal of Presumption of Abuse in response to a § 707(b) motion to dismiss. It contained figures of the debtor's income and expenses that contradicted figures in his Form B22A. Attorney did not review the debtor's paystubs for clarification. He also omitted several bank accounts from the schedules. Attorney blamed it on his client's faulty memory. Court held the inconsistencies in the various documents he filed for his client placed a duty on him to inquire further. *In re Withrow*, 405 B.R. 505 (1st Cir. BAP 2009).

2. Attorney noted litigation in the SOFA but did not disclose its settlement, which resulted in a promissory note payable to the debtor, with an approximate balance of $61,000 and debtor had been receiving regular payments on it from the payor. The debtor had given the attorney a settlement binder, which included this note. Attorney did not review the documents. When the note came up in questioning at the § 341 meeting, the attorney misled the trustee into thinking its balance was less than an amount that would be exempt under a wild card exemption. The court found the attorney's lack of candor "egregious" and imposed a $20,000 sanction against him, which the BAP affirmed. *In re Kayne*, 453 B.R. 372 (9th Cir. BAP 2011).

3. At the first client meeting, the debtor informed the attorney that he owned 100% of his home. After this meeting, he transferred his interest to his non-filing spouse. When the attorney met again with the client prior to filing, he did not inquire as to whether any of the information had changed. The court did not, however, impose sanctions because it did not believe the debtor would have disclosed this change if the attorney had asked the question. *In re Gutierrez*, 356 B.R. 496 (Bankr. N.D. Cal. 2006).

4. The attorney filed a chapter 7 case to stop the client's garnishment on a judgment. He did not review the judgment itself before filing, but if he had he would have discovered it was a judgment for fraud and, therefore, nondischargeable. If he had made this discovery, he would have counseled his client that bankruptcy would only give the client a temporary breathing space from this garnishment. The attorney saw that the garnishing creditor was a hospital and assumed it was for medical services rendered. In fact, it was for a sanction imposed by the court for a frivolous complaint filed by the debtor against his employer, which happened to be a hospital. *Dignity Health v. Seare (In re Seare)*, 493 B.R. 158, 209 (Bankr. D. Nev. 2013).

A common thread running through these cases is that debtor's counsel must ask the client for documentation sufficient to complete the schedules and SOFA, he must review the

documents given, and, if inconsistencies or other red flags are evident, the inquiry must go further. Courts also require that counsel "explain the requirement of full, complete, accurate, and honest disclosure . . . [and that counsel] check the debtor's responses . . . to assure they are internally and externally consistent . . ." *In re Garrad*, 2013 WL 4009324, at *4 (Bankr. N.D. Ala. Aug. 5, 2013); *see also In re Armwood*, 175 B.R. 779, 790 (Bankr. N.D. Ga. 1994) (pre-BAPCPA); *In re Huerta*, 137 B.R. 356, 379 (Bankr. C.D. Cal. 1992) (pre-BAPCPA).

Commentators have opined that debtor's attorneys "should always review relevant court records, online title and lien searches, tax transcripts, and other readily available documents." G. Thomas Curran Jr., *How Much Diligence is Due?*, 32 Am. Bankr. Inst. J. 24, 25 (Nov. 2013). One court held that the attorney must verify the debtor's statement that he has not filed any prior bankruptcy cases by conducting a PACER search. *In re Casavalencia*, 389 B.R. 292 (Bankr. S.D. Fla. 2008). And the attorney must confirm the client's identity. *Id.* There is a balance to be struck, however, between being too thorough, which could price the attorney's services out of the debtor's reach, and being too lax in the face of obvious red flags and inconsistencies. It must, therefore, be a "cost-effective investigation." *Id.* If the documents received lead to further questions, the attorney must follow the trail. For example, if the debtor's tax return reveals interest earned on bank accounts or K-1s for entities that are not listed in schedule B, then the attorney must inquire further.

If the attorney has a duty to consult readily available "external verification tools," must the attorney also check the debtor's use of social media? For a thoughtful exploration of this subject, see *The Ethical Duty of Investigation: Does it Reach Social Media?*, American Bankruptcy Institute Northeast Consumer Forum, July 17-19, 2014, 071714 ABI-CLE 409. This commentary suggests that the lawyer should ask the client for an inventory of what social media sites the client has used, advise the client to be cautious in future postings, and then the attorney should review the sites for possible problems. It raises the question of whether it would be proper to advise the client to take down postings or to refuse to "friend" strangers, who might be the debtor's trustee.

III. DUTY TO PRESERVE ELECTRONIC RECORDS

This section is intended only to highlight one specific issue relating to a firm's electronic records. It arises when a law firm undertakes to evaluate whether the estate holds claims against third parties. In the case of *Weinman v. Nat'l Union Fire Ins. Co.*, Adversary Proceeding No. 09-1150 (Bankr. D. Colo. May 11, 2015), the liquidating trustee appointed in the confirmed chapter 11 plan asserted claims for insurance coverage under fidelity bonds for the alleged "dishonest and fraudulent acts" of the debtor's principals. Claims against the principals and the debtor's insurers were the primary assets from which unsecured creditors hoped for a recovery. One of the central issues in this case was whether the estate's representatives had submitted a timely notice of claim on the bonds. The answer to this question depended on when the debtor or its representatives discovered the alleged fraud. Following extensive discovery, the defendants sought dismissal on the basis of alleged spoliation of evidence. They argued that evidence critical to establishing the date of debtor's discovery of the losses has been lost because the debtor's chief restructuring officer (the "CRO") and two law firms employed by the debtor had failed to preserve all of their debtor-related emails. The defendants argued that the failure to

preserve the emails constituted spoliation of evidence so pervasive and prejudicial that the most severe sanction – dismissal of the trustee's complaint – was warranted.

The CRO, through his closely-held corporation, was hired as a turnaround consultant. He served as the debtor's CRO throughout the chapter 11 case. He was never a direct employee of the debtor and did not use any of the debtor's computers for his work. Instead he used his personal laptop. Unfortunately, he did not preserve its data on any backup servers. His laptop became infected with a virus. He tried valiantly to retrieve the data with assistance from IT professionals, but he was never able to recover more than a few personal documents.

One of the two law firms involved acted as debtor's primary counsel ("DIP Counsel") and the other acted as local counsel ("Local Counsel"). DIP Counsel handled the sale of substantially all of the debtor's assets and then terminated its representation. At that time, Local Counsel took over and eventually proposed the debtor's liquidating plan of reorganization.

DIP Counsel's normal practice regarding emails was to save important emails in an electronic folder for a particular case. Then, in the absence of a litigation hold, its attorneys would delete the entire folder ninety days or more after a matter was concluded, depending on the nature and size of the matter. In accordance with this normal practice, DIP Counsel attorneys deleted their debtor-related email folders sometime within one year after the completion of their work for the debtor.

The primary attorney responsible at the Local Counsel firm testified that he received many emails in the course of the debtor's case. He printed hard copies of emails that he thought were important, that he might need to refer to in the future, or that he might want others to see. Emails that were, in his mind "of no import," such as "How was your weekend?" or "How are the kids?" he either deleted immediately or left in his electronic in-box. He never affirmatively deleted nor directed anyone else to delete any important emails related to this case.

During the years in question, however, the email system at the Local Counsel firm automatically moved an email that was not saved in a user-created folder to a "deleted items folder" 150 days after it was sent or received. After 30 days in the "deleted items folder," or a total of 180 days after it was sent or received, an email that was not specifically placed in a user-created folder, or otherwise preserved, would be automatically purged from the email system. Purged emails would be preserved for an additional five weeks on backup tapes but, after that time, may not have been accessible in any electronic form.

The CRO and these two firms undertook an initial investigation into whether the debtor's principals had committed fraud and whether the debtor could assert claims under the fidelity bonds. The defendants believed that their email records would have established an earlier date of discovery.

Federal courts have "inherent power" to impose sanctions for the destruction or loss of evidence that occurs before or outside of the formal discovery process. *Silvestri v. Gen. Motors Corp.*, 271 F.3d 583, 590 (4th Cir. 2001); *Jordan F. Miller Corp. v. Mid-Continent Aircraft Serv., Inc.*, 1998 WL 68879, at *3 (10th Cir. Feb. 20, 1998) ("*Miller*"). "The power is limited to

that necessary to redress conduct 'which abuses the judicial process.'" *Silvestri*, 271 F.3d at 590 (citing *Chambers v. NASCO, Inc*., 501 U.S. 32, 45-46 (1991)). The policy underlying this inherent power, and the basis for any sanctions to be imposed, is to preserve the integrity of the judicial process by punishing those who have destroyed evidence, deter future abuses, promote accurate fact finding by the court or jury, remedy any evidentiary imbalance caused by spoliation, and compensate the injured party for additional expenses incurred as a result of any improper conduct. *Silvestri*, 271 F.3d at 590; *Austin v. City and Cty. of Denver*, 2006 U.S. Dist. LEXIS 47451, at *8 (D. Colo. July 13, 2006).

Sanctions may be imposed for spoliation of evidence if "(1) a party has a duty to preserve evidence because it knew, or should have known, that litigation was imminent, and (2) the adverse party was prejudiced by the destruction of the evidence." *Turner v. Public Serv. Co. of Colo.*, 563 F.3d 1136, 1149 (10th Cir. 2009). The critical factors to evaluate when determining appropriate sanctions to impose for spoliation are: (1) the culpability of the responsible party and (2) the degree of actual prejudice to the other party. *Miller*, 1998 WL 68879, at *4. "The party seeking sanctions has the burden of proving the essential elements of a spoliation claim." *Oto Software, Inc. v. Highwall Tech., LLC*, 2010 WL 3842434, at *7 (D. Colo. August 6, 2010). Whether to impose sanctions for spoliation and the determination of what sanctions are appropriate are matters committed to the trial court's discretion. *Turner*, 563 F.3d at 1150; *Burlington N. & Santa Fe Ry. Co. v. Grant*, 505 F.3d 1013, 1032 (10th Cir. 2007). A court should select the least drastic sanction necessary to vindicate the purpose for which it is imposed. *Miller*, 1998 WL 68879, at *6.

A spoliation claim may not be decided on the basis of speculation. *Turner*, 563 F.3d at 1150 (upholding trial court's decision not to impose sanctions where there was no evidence of actual, rather than merely theoretical, prejudice). Where documents no longer exist, a party need not conclusively demonstrate that the evidence would have established liability on the part of spoliator, but it must at least have plausible concrete suggestions of what the evidence would have been. *Gates Rubber Co. v. Bando Chem. Indus., Ltd.*, 167 F.R.D. 90, 104-105 (D. Colo. 1996). Courts do not always require proof of bad faith on the part of the spoliator for a dispositive sanction such as dismissal. *Miller*, 1998 WL 68879, at *7. To justify this most extreme sanction in the absence of bad faith, however, the destruction of the evidence must severely prejudice the opposing party. *See Gates*, 167 F.R.D. at 102-03; *Comput. Assoc. Int'l, Inc. v. Am. Fundware, Inc*., 133 F.R.D. 166 (D. Colo. 1990) (dispositive sanction is a last resort to be invoked only if misconduct is willful or in bad faith, serious prejudice results, and alternative sanctions would not be adequate).

Prejudice deserving of a dispositive sanction may occur in cases where there is no substitute for the destroyed evidence and the opposing party is practically unable to pursue or defend a claim without it. For example, in *Miller*, the plaintiff sued for damages resulting from the crash of an airplane that the plaintiff claimed was caused by the failure of its landing gear. The landing gear was destroyed before the defendant's experts had a chance to examine it. The Tenth Circuit upheld dismissal of the plaintiff's claim where there was no adequate substitute for visual inspection of the landing gear by the defendant's experts. *Miller*, 1998 WL 68879, at *6-7.

As summarized by the Fourth Circuit:

> At bottom, to justify the harsh sanction of dismissal, the district court must consider both the spoliator's conduct and the prejudice caused and be able to conclude either (1) that the spoliator's conduct was so egregious as to amount to a forfeiture of his claim, or (2) that the effect of the spoliator's conduct was so prejudicial that it substantially denied the defendant the ability to defend the claim.

Silvestri v. Gen. Motors Corp., 271 F.3d 583, 593 (4th Cir. 2001).

In the Centrix case, there were many attorneys, employees of the debtor and other recipients of emails during the case. The defendants did not seek discovery from other significant sources. For this reason, the only evidence made completely unavailable to them were the emails between the CRO and the two law firms *and no one else.* If a particular email was sent or copied to other people, then the failure of the CRO and these two firms to preserve their Centrix emails did not establish that such evidence was "destroyed" or rendered permanently unavailable to the defendants, because it was at least theoretically available from other sources. Moreover, the defendants had access to plenty of other information concerning the timing of the discovery. What the defendants lacked was a "smoking gun" – an email of outright admission by the debtor's representatives as to their determination that the principals had committed fraud and/or that coverage under the bonds claims existed for these acts so that the defendants could establish the earliest possible date of discovery. Despite thousands of pages of evidence and hours of testimony, the court was unpersuaded that such an email ever existed. The court, therefore, was unable to conclude that the failure to preserve the lost emails so hindered the defendants in the presentation of their timeliness defense that the severe sanction of dismissal was warranted.

But this case serves as a cautionary tale for attorneys and other professionals employed to assess possible claims of the estate against third parties. Professionals should educate themselves as to how and how long their electronic evidence is automatically preserved on their systems. They should take any additional steps necessary to preserve these records. They should also consider whether they want to place themselves in the position of being witnesses as to the debtor's discovery of claims. In cases in which insurance claims are a significant potential source of recovery and if the debtor's budget permits, the professionals should consider engaging a consultant to conduct this form of investigation.

IV. BANKRUPTCY FEES: A SLEIGHT OF HAND

A robust economy is bad news for bankruptcy professionals. Case filings nationwide are on a downward trend. With fewer cases, our court has noticed several disturbing trends. Some of these stem from increased competition for the more limited pool of cases. Others relate to attempts to squeeze every possible dollar out of the case at hand by over billing and over litigating matters.

A. Problematic Fee Arrangements

The effort to beat the competition for consumer debtor cases has driven some attorneys to offer the following problematic fee arrangements:

1. Unbundling of Legal Services

Many consumer debtor lawyers seek to capture a larger market share by offering a lower fee. On the surface, there is nothing wrong with that practice. Often, however, they are able to offer the lower fee by severely curtailing the nature and extent of their legal representation. This practice is known as "unbundling." It is a practice borrowed from the domestic relations realm, where parties who wanted an amicable, uncontested divorce could contract for "bare bones" legal representation and then complete the rest of the process *pro se*. State courts have allowed this practice in response to the rising costs of full legal representation. As it has spilled over into the bankruptcy world, this practice has resulted in law firms contracting only to advise the debtor on a filing, to complete the initial filing package, and to attend the § 341 creditors' meeting. After this point, the debtor is left to fend for himself as to any deficiencies in the filing, with any exemption disputes, reaffirmation agreements, motions for stay relief or to dismiss the case, and the like. Law firms that unbundle their services in this manner function as little more than bankruptcy petition preparers.

Local rules in most districts specify whether unbundling is permitted and to what extent. Courts vary widely on their approach to this issue, from prohibiting any unbundling, to allowing complete unbundling, to a middle approach that limits unbundling to specific matters, such as adversary proceedings. *In re Burton*, 442 B.R. 421, 453 (Bankr. W.D.N.C. 2009) (prohibiting any unbundling). Some judges have published decisions in which they have taken a position on the permissible scope of unbundling. For example, in *In re Ortiz*, 496 B.R. 144, 149 (Bankr. S.D.N.Y. 2013), the court held that counsel could not "unbundle" his attendance at the § 341 creditors' meeting. Some courts do not allow unbundling of the attorney's duty to advise chapter 7 debtors on whether a reaffirmation agreement is in their best interests. *In re Minardi*, 399 B.R. 841, 848 (Bankr. N.D. Okla. 2009); *In re Perez*, 2010 WL 2737187, at *3 (Bankr. D.N.M. July 12, 2010) (*citing In re Minardi*, 399 B.R. at 848); *In re Castorena*, 270 B.R. 504 (Bankr. D. Idaho 2001).

Even when unbundling is permitted, however, attorneys must always comply with their ethical obligations. The Model Rules of Professional Conduct (the "Model Code") allow a great deal of flexibility in regard to lawyers and clients contracting for limited services, provided that the attorneys satisfy two essential conditions. "A lawyer may limit the scope of the representation if the limitation is reasonable under the circumstances and the client gives informed consent." Model Rules of Prof'l Conduct R. 1.2(c) (Am. Bar Ass'n 1983). A third condition appears in Rule 1.1 of the Model Code, which is the duty of competence. Limiting the scope of services does not in any way lessen the attorney's duty of competence.

The extent of unbundling must be reasonable under the circumstances of the debtor's particular case. The attorney needs to understand the goals that the client is attempting to achieve through the bankruptcy process. As long as those goals can be met and other services

are tangential to the goals, then the attorney may limit the services accordingly. For example, if the debtor's main goal in filing a chapter 13 case is to save his residence, it would not be reasonable for the attorney to limit the representation to exclude defense of a stay relief motion. If the goal is to obtain a discharge, then "competency demands that an attorney for an individual Chapter 7 debtor . . . perform *all* of the legal services needed for that individual to obtain a discharge and retain their [sic] exempt property . . . ." *In re Slabbinck*, 482 B.R. 576, 590 (Bankr. E.D. Mich. 2012) (emphasis in original). This inquiry is fact specific and "depends on the client's reasonable pre-consultation goals and how they may have been shaped or refocused through consultation with the attorney." Hon. Thomas F. Waldron, *Undulations in Unbundling – Is a Ripple Running Through the Rocks of Resistance in Bankruptcy Courts?*, 6 Norton Bankr. L. Adviser 1, June 2013, Issue 6 (quoting *In re Seare*, 493 B.R. 158 (Bankr. D. Nev. 2013)). It is the client's goals that drive this analysis, not the attorney's compensation objectives.

Obtaining the client's *informed* consent to limited representation presents added challenges. It involves two facets: (1) what information disclosure is sufficient; and (2) has the consent been validly obtained. As one bankruptcy court aptly stated:

> Disclosure involves the attorney explaining to a debtor the nature of the bankruptcy process, what problems could or will be encountered, how those problems should be addressed, and the risks or hazards, if any, associated with those problems. Consent involves a clear understanding on the part of the debtor as to these factors and the possible results of a debtor proceeding without an attorney being present.

In re Bancroft, 204 B.R. 548, 552 (Bankr. C.D. Ill. 1997).

While bankruptcy courts are inherently cautious about unbundling and even skeptical about an attorney's ability to satisfy his ethical duties when unbundling, there is a push in the academic community to view this issue from the broader perspective of "access to justice." No one would dispute that BAPCPA imposed significant additional duties on consumer debtors, driving up the cost of even the most basic chapter 7 filing. Sometimes those who need bankruptcy the most are least able to pay for "full service." An unbundled attorney may be better than none. Carl A. Pierce, *When Less Legal Service May Mean More Access to Justice: Limited Scope Representation for Self-Represented Litigants*, 41 Tenn. B.J. 22 (Feb. 2005). Some advocate for a regulated system overseeing an expanded role for bankruptcy petition preparers. Michael D. Sousa, *Legitimizing Bankruptcy Petition Preparers: A Sociolegal Prescription for Change*, 89 Am. Bankr. L.J. 269 (Spring 2015).

Whether unbundling should be expanded is a fair question for debate. But any amount of unbundling must not cause the attorney to fail to satisfy his ethical duties to his client. "'Attorneys must never lose sight of the fact that the profession is a branch of the administration of justice and *not a mere money-making trade.*'" Waldron, *Undulations*, *supra* (quoting *In re Pair*, 77 B.R. 976, 978 (Bankr. N.D. Ga. 1987)). "'A lawyer walks a perilous path in attempting to limit the services provided to bankruptcy debtors.'" *Id.* (quoting Hon. Jim D. Pappas, *Simple Solutions = Big Problem*, 46 Advocate (Idaho) 31, 33 (2003)).

To end with one practical consideration, attorneys should consider formal withdrawal from the case when they believe they have completed all of the work they have contracted to provide. Otherwise, they may actually do harm to their clients. When the attorney is still attorney of record, the mortgage company's attorney cannot ethically speak directly to the debtor. At countless stay relief hearings, creditor's counsel have expressed the desire to attempt a stipulated resolution of the motion, giving the debtor additional time to cure defaults, but counsel cannot engage in these type of negotiations because creditor's counsel cannot reach debtor's counsel and is not permitted to speak directly with the debtor.

2. "Bait and Switch" Fee Offers

"Bait and switch" schemes are nothing new in the business world. But this practice has been creeping into the world of consumer bankruptcy. For example, Lawyer A in Colorado has advertised his services extensively, claiming that he will prepare and file a chapter 7 bankruptcy case for $500, with "no additional fees." Anytime anyone "googles" to find a bankruptcy attorney in Colorado, his advertisements pop up. Yet many consumer debtor attorneys in the district claim that he never actually files a chapter 7 for $500. Once he meets with the client, he tacks on fee after fee until his actual fee is approximately $2,000.

Another consumer debtor attorney, Lawyer B, recently sued Lawyer A in federal district court claiming that this alleged practice of false advertising violated the Lanham Act, 15 U.S.C. § 1125(a)(1)(A-B) and the Colorado Consumer Protection Act ("CCPA"), Colo. Rev. Stat. § 6-1-105. *Berken v. Jude*, Case No. 12-cv-02555-RPM (D. Colo. Sept. 26, 2012) To prevail on a claim of false advertising under the Lanham Act, the plaintiff must establish: (1) defendant made a false or misleading representation of fact in a commercial advertisement about his services; (2) the misrepresentation likely influenced the consumer's purchasing decision; (3) the misrepresentation actually deceived or has the tendency to deceive a substantial segment of its audience; (4) defendant placed the misrepresentation into interstate commerce; and (5) plaintiff has been or is likely to be injured because of the misrepresentation. *See Zoller Labs., LLC v. NBTY, Inc.*, 111 Fed. App'x 978, 982 (10th Cir. 2004) (quoting *Scott Co. v. United Indus. Corp.*, 315 F.3d 264, 272 (4th Cir. 2002) (collecting cases)). In this case, the court entered summary judgment against Lawyer B because he could not prove that he, as a competing attorney, had suffered actual injury caused by Lawyer A's advertisements. It simply was not enough to show the ads were actually false or misleading.

A claim under the CCPA has substantially the same elements. A plaintiff must show: (1) that defendant engaged in an unfair or deceptive trade practice; (2) that the challenged practice occurred in the course of defendant's business; (3) that the practice significantly impacts the public as actual or potential consumers of defendant's business; (4) that plaintiff suffered injury in fact to a legally protected interest; and (5) that the challenged practice caused plaintiff's injury. *See Crowe v. Tull*, 126 P.3d 196, 201 (Colo. 2006). For the same reasons, the court granted summary judgment against Lawyer B on this claim as well.

Lawyer A was lucky this time. If he ends up cross-wise with a client in the future, he may not be so lucky the next time around. Model Rule of Professional Conduct § 7.1 prohibits such false advertising. "A lawyer shall not make a false or misleading communication about the

lawyer or the lawyer's services. A communication is false or misleading if it contains a material misrepresentation of fact or law, or omits a fact necessary to make the statement considered as a whole not materially misleading." *Id.* Or other consumer debtor attorneys might band together and marshal the necessary proof to try this again.

3. "No Money Down" & Reaffirmed Fee Debts

Some attorneys have attracted large market shares by offering a "zero-down" payment option to debtors. Under this program, the client get the benefit of being able to file bankruptcy quickly even though they have no present ability to pay a bankruptcy attorney. They sign a promissory note and a reaffirmation agreement to pay the fees post-petition on an installment basis. One attorney is Colorado ("Lawyer X") enhanced his firm's ability to collect these fees by requiring clients to sign documents establishing an automatic bank account withdrawal or debit card transaction. The fees were then paid on a bi-weekly basis through these automatic payments. His disclosures informed the client that reaffirmation was "voluntary," but he would not provide services without it. He promised to obtain court approval of the reaffirmation agreements, but often failed to do so.

Lawyer X's program was so successful that he was grossing over $2,000,000 per year in fees. The rest of the consumer bar was outraged and lying in wait to bring about his downfall. It took only one dissatisfied debtor to accomplish this. This client returned to Lawyer X's office to request representation on a motion for stay relief. Lawyer X refused to assist without the payment of an additional fee. Lacking the ability to pay, the client visited another consumer debtor's attorney ("Lawyer Y"). That lawyer reviewed the client's situation and advised him that Lawyer X had violated the automatic stay and he could recover substantial damages for him on a contingency fee basis. When this practice came to light, the U.S. Trustee's office followed suit, bringing a similar complaint on behalf of debtors in approximately 600 other cases. The second suit settled on terms that required Lawyer X to disgorge about $500,000 in fees. Lawyer Y was undeterred by the U.S. Trustee settlement and continued to prosecute his stay violation complaint, which resulted in a substantial award of attorney's fees and punitive damages. Soon thereafter, the presiding disciplinary judge for the State of Colorado suspended Lawyer X from practice. Lawyer X filed his own bankruptcy case but, of course, the sanctions leveled against him in both suits are non-dischargeable.

Initially, Lawyer X attempted to defend himself against liability, relying on a small minority view that bankruptcy attorney fees are non-dischargeable, thereby permitting an attorney to collect those fees from non-estate assets after the case is filed. *In re Perry*, 225 B.R. 497, 500-01 (Bankr. D. Colo. 1998); *In re Mills*, 170 B.R. 404, 411-12 (Bankr. D. Ariz. 1994). These courts recognize that the Bankruptcy Code does not contain an explicit exception for the dischargeability of attorney fee debts, but they nevertheless created a judicial exception based on public policy concerns. As one court put it, "[t]he ability of indigent debtors to gain access to the bankruptcy court through legal representation is a strong public policy concern which weighs in favor of allowing such debtors to enter into fee agreements whereby all, or a portion, of the legal fees are payable post-petition." *In re Perry*, 225 B.R. at 500. The Ninth Circuit has joined this minority position, but limited the exception by requiring the apportionment of a flat fee between work performed pre- and postpetition (even if the flat fee agreement does not call for

apportionment), and allowing the debtor's attorney only to collect the amount attributable to postpetition work. *Gordon v. Hines* (*In re Hines)*, 147 F.3d 1185, 1190-91 (9th Cir. 1998). The Ninth Circuit also based its reasoning on public policy grounds, stating that "the very administration of the bankruptcy system requires that attorneys for Chapter 7 debtors must have a legally enforceable right for their postpetition services that were contracted for before filing of the petition." *Id.* at 1191.

Most courts, however, consider the fees to be a prepetition debt. *Bethea v. Robert J. Adams & Assocs.*, 352 F.3d 1125, 1128-29 (7th Cir. 2003); *In re Martin*, 197 B.R. 120, 126-27 (Bankr. D. Colo. 1996); *In re Waldo*, 417 B.R. 854, 880-83 (Bankr. E.D. Tenn. 2009); *In re Mansfield*, 394 B.R. 783, 787 (Bankr. E.D. Pa. 2008). Because it is a prepetition debt, the automatic stay prevents the debtor's attorney from collecting the debt postpetition and the debtor may discharge the debt in the bankruptcy case. *Bethea*, 352 F.3d at 1128; *In re Martin*, 197 B.R. at 127; 11 U.S.C. § 362(a)(6).

Lawyer X attempted to insulate himself from liability for a stay violation through the reaffirmation process. The Code permits debtors to reaffirm all or a part of an otherwise dischargeable prepetition debt. However, the use of such agreements is strictly regulated by the Code. *See* 11 U.S.C. § 524(c).

A few courts have approved or indicated a willingness to approve the use of reaffirmation agreements between a chapter 7 debtor and the debtor's bankruptcy counsel for prepetition legal fees. *See Hessinger & Assocs. V. Voglio (In re Voglio)*, 191 B.R. 420 (D. Ariz. 1996); *Hessinger & Assocs. V. U.S. Trustee (In re Biggar)*, 185 B.R. 825 (N.D. Ca. 1995); *In re Perez*, 177 B.R. 319 (Bankr. D. Neb. 1995); *In re Symes*, 174 B.R. 114 (Bankr. D. Ariz. 1994); *In re Pasco*, 220 B.R. 119 (Bankr. D. Colo. 1998). Even these courts, however, have noted the complicated ethical concerns inherent in such agreements. *See Gordon v. Hines* (*In re Hines)*, 147 F.3d 1185, 1191 (9th Cir. 1998). As noted by the Ninth Circuit:

> Where the creditor is the debtor's own attorney, the conflict of interest involved is obvious: How can the lawyer advise the debtor fully and effectively where the lawyer himself or herself is on the other side of the bargaining table from the client? And if ethical or court rules obligate the attorney to continue representation in all events, what incentive exists for a fully informed client to undertake voluntarily a legally enforceable obligation to pay attorneys' fees? Indeed, in that event the fiduciary obligation of the attorney to provide full disclosure would seem to call for recommending against reaffirmation.

Id. at 1190.

Due to these ethical concerns, courts engage in greater scrutiny when reviewing reaffirmation agreements for attorney's fees and require detailed and full disclosure that the fees are dischargeable. *In re Pasco*, 220 B.R. at 123 (requiring that the debtor be told in plain, conspicuous, written terms that the fee is dischargeable). Furthermore, because an agreement between counsel and a debtor is, by its nature, a conflict of interest, courts consider any debtor seeking to enter into such an agreement to be without representation by an attorney in the

negotiation of the agreement. When the debtor is unrepresented, § 524(d) requires the bankruptcy court to hold a hearing, with the debtor in attendance, at which the court must determine whether the agreement imposes an undue hardship on the debtor and if it is in the best interests of the debtor. 11 U.S.C. § 524(c)(6), (d)(2). If, and only if, the court makes appropriate findings and approves the reaffirmation agreement, does the debt become nondischargeable. Even if it is a nondischargeable debt, the creditor may not begin collection activity on the debt until after the automatic stay has terminated. 11 U.S.C. § 362(c).

Of course, a court would be hard pressed to find that reaffirmation was in the debtor's best interests. A debtor can instead voluntarily pay the attorney fees without incurring the legal obligation to do so. After the filing, a majority of the attorney's work has already has been completed and so the debtor realizes very little value from reaffirmation. The only real benefit flows to the attorney, who gains the ability to enforce the debt if payments stop. In Lawyer X's cases, the debtors had agreed to pay on a postpetition basis more than double the market rate for a chapter 7 filing, making it even less likely that the courts would approve the reaffirmation agreements. When he did not secure court approval, Lawyer X simply stopped filing the reaffirmation agreements. He did, however, continue to receive the automated payments.

Clients who are willing to pay double the usual fee in order to have the benefit of a zero-down arrangement are often the most desperate and vulnerable debtors. They are usually faced with garnishments and foreclosures. In these dire circumstances, it would be difficult to find that their consent to reaffirmation was truly an informed one. They would be likely to sign anything put in front of them in order to obtain bankruptcy relief.

B. Overly Litigious Conduct

In the world of business bankruptcies, there is a phenomenon occurring that is the opposite of unbundling. In the district of Colorado, bankruptcy filings have dropped dramatically, by at least one-third in number. Yet the number of motions filed and the amount of court time recorded has nearly doubled. Lawyers are fighting about everything. Often they are incurring more in legal fees than the amount in controversy. Some of this is attributable to a changing economy, where questions of valuation and future business prospects are in flux. More often than not, it appears that lawyers are simply trying to stay busy. I have seen lawyers file not one, or two, but three serial motions to dismiss a complaint. And it is not uncommon to see attorneys fight over a request for a brief extension of time. The discovery disputes are seemingly endless. Worse, the minute an attorney finds he has won his client's position, he immediately follows the victory with a request for fees against the opposing party and his counsel.

Unless the lawyer's positions are frivolous, this behavior may not be actionable. The Model Rules of Professional Conduct § 3.1 provides only that "[a] lawyer shall not bring or defend a proceeding, or assert or controvert an issue therein, unless there is a basis in law and fact for doing so that is not frivolous, which includes a good faith argument for an extension, modification or reversal of existing law." Rule 9011 is limited to the same type of conduct. On the other hand, the lawyer's client might be vulnerable to suit on a counterclaim for vexatious conduct or abuse of process is the facts are sufficiently egregious. Whether this vexatious

conduct is actionable against the attorney or not, this type of behavior will earn an attorney the type of reputation that will not foster a long and successful career.