PROTECTING PRE-PETITION ATTORNEY'S FEE PAYMENTS

MARCH 2013

If a client files for bankruptcy, an attorney risks losing not only the amount of legal fees outstanding at the time of bankruptcy, but also fees paid up to one year prior to the bankruptcy filing.

There are three main ways in which the fees an attorney received for representing a debtor pre-bankruptcy may be in jeopardy: (1) section 542 turnover; (2) section 547 preference actions; and (3) section 329 disgorgement. Fortunately, if attorneys properly structure their retainer agreements and invoice and payment schedules, legal fees paid pre-petition can be protected against attacks from trustees in bankruptcy.

TURNOVER

Section 542(a) of the Bankruptcy Code requires anyone in possession of property of the bankruptcy estate to turnover that property to the trustee. Retainer agreements are particularly vulnerable to turnover, and an attorney's ability to keep a retainer following a client's bankruptcy largely depends on the type of retainer agreement used.

There are three main types of retainer agreements, each of which is treated differently in bankruptcy. *See In re King*, 392 B.R. 62, 70 (Bankr. S.D.N.Y. 2008) (reviewing the different types of retainer agreements and the issues pertaining to an attorney's risks regarding each different type). A "classic" retainer secures an attorney's availability over a certain period of time as opposed to being compensation for services rendered. An attorney earns the entire amount of a classic retainer at the time the debtor pays it. The debtor retains no interest in the retainer, and it does not become property of the bankruptcy estate. Thus, there is no risk of turnover with a classic retainer.

An "advance payment" retainer "involves fees paid to an attorney for services to be rendered, but the payment passes to counsel upon remittance at which time the debtor relinquishes all interest in the monies, unless there is an express agreement for the payment to be held in a trust or escrow." Advance payment retainers do not become property of the bankruptcy estate and are not subject to turnover, but may be subject to disgorgement under section 329, which is discussed in further detail below.

A "security retainer" is a payment made to an attorney to secure payment of fees for *prospective* services. With a security retainer arrangement, the debtor retains an interest in the funds until services are rendered by the attorney. In other words, the attorney merely "holds" the funds until services are rendered, and is required to turn over any remaining balance to the debtor. Because the debtor retains an interest in the retainer funds, the funds are property of the bankruptcy estate and are subject to turnover.

PREFERENCE ACTIONS

Stated simply, a preference under Bankruptcy Code section 547(b) is a payment made by a debtor to a creditor during the 90-day period preceding bankruptcy. The trustee can avoid and recover the value of preferential payments from creditors in order to satisfy claims of creditors.

It is important to note that the payment must be to a creditor on account of antecedent debt. Attorneys representing debtors prior to a bankruptcy filing can qualify as creditors unless precautions are taken regarding payment of fees. Clearly, if the attorney is not paid prior to a debtor's bankruptcy filing, the attorney will have an unsecured claim against the bankruptcy estate for the amount of the unpaid fees. This is not a desirable position to be in, however, because unsecured claims in bankruptcy are often paid mere pennies on the dollar, if at all. Additionally, pre-petition attorney's fees claims are subject to discharge in the debtor's bankruptcy. *See In re Klein*, 197 B.R. 760, 762–63 (Bankr. E.D.N.Y. 1996).

To avoid having pre-petition fee payments attacked by trustees in bankruptcy as preference payments, attorneys should schedule their payments such that they are not made on account of antecedent debt. This can be done under an advance retainer, as discussed above, though there are other risks, discussed below. Alternatively, a security retainer could be used, though it leaves some of the client's payment exposed.

The key is that the exchange between the client and the attorney should be contemporaneous. Courts generally agree that legal fee claims arise when the legal services are performed, not when the bill itself is presented to the client. *See In re First Jersey Securities, Inc.*, 180 F.3d 504, 511 (3d Cir. 1999). Clearly, there is no hard and past protection for the attorney, but use of these kinds of retainers can limit chances that a trustee will seek recovery of payments for actual services rendered.

Another weapon for the attorney is the "ordinary course of business defense" that provides two different options for protecting pre-petition payments: (1) if the payment was made in the ordinary course of affairs between the debtor and the creditor; or (2) if the payment was made according to ordinary business terms.

If the attorney and debtor dealt regularly with one another pre-petition, the first option of the ordinary course of business defense, which looks subjectively to the pre-petition dealings of the attorney and the client, may protect the attorney from having to return fees it received within 90 days of the debtor's bankruptcy. *See In re Interco Systems, Inc.*, 202 B.R. 188, 195–96 (Bankr. W.D.N.Y. 1996). Even if the parties did not have substantial pre-bankruptcy dealings with one another, however, the objective second option of the ordinary course of business defense, which looks objectively to ordinary business terms, may protect a payment made to an attorney for even a single, non-recurring arrangement with a debtor pre-petition. *See In re BCE West, L.P.*, Bankr. No. 98-12547-PHX-CGC, 2008 WL 565262, at *5 (Bankr. D. Ariz. Feb. 28, 2008).

DISGORGEMENT

Section 329(a) of the Bankruptcy Code provides that an attorney representing a debtor in or in connection with a bankruptcy case "shall file with the court a statement of the compensation paid or agreed to be paid, if such payment or agreement was made after one year before the date of the filing of the petition, for services rendered or to be rendered in contemplation of or in connection with the case by such attorney, and the source of such compensation." If the court finds that "such compensation exceeds the reasonable value of any such services," section 329(b) authorizes the court "cancel any such agreement, or order the return of any such payment, to the extent excessive." In other words, section 329 allows the court to review fees paid to an attorney within one year prior to bankruptcy and order the attorney to disgorge any portion of the fees that the court determines to be unreasonable.

While the text of this provision seems to apply only to the attorneys involved in matters related to the bankruptcy filing, some courts have taken an expansive view of section 329(a), bringing underneath its coverage arrangements with attorneys not directly involved in preparing for a filing the debtor's bankruptcy. For example, one court found that a law firm that agreed prior to the debtor's bankruptcy to represent him in connection with criminal and regulatory investigations relating to the debtor's business performed legal services "connected to" and "in contemplation of" the debtor's bankruptcy. *See In re Rheuban*, 121 B.R. 368, 377–78 (Bankr. C.D. Cal. 1990). Accordingly, the court reviewed the compensation agreement for reasonableness and ordered the law firm to disgorge nearly $200,000.00 in fees received pre-bankruptcy. While this decision may be an outlier, it is important for attorneys dealing with potential future debtors to consider the possibility of later attacks by a trustee seeking repayment of fees paid for pre-petition legal services, even those seemingly unrelated to the debtor's bankruptcy.