Volume 14
Number 1 *Fall, 1983*

Article 7

1983

Attorney Compensation in Bankruptcy: The Ethical Obligation

Kimberly S. Armstrong

Attorney Compensation in Bankruptcy: THE ETHICAL OBLIGATION

Kimberly S. Armstrong*

The Bankruptcy Act of 1898 and the Bankruptcy Reform Act of 1978 ("the Code") have few advocates among creditors of individuals and businesses electing to declare bankruptcy. Much criticism is focused upon the payments of legal fees out of the estate to the debtor's attorney immediately prior to the filing of the bankruptcy petition. Were these payments made to another creditor, they might receive greater scrutiny.

Unlike post-petition legal fees, pre-petition fees are not subject to avoidance by the trustee in bankruptcy or by the court; therefore, it is customary for bankruptcy attorneys to require that their fees be paid prior to the filing of the petition. To recover any outstanding balance remaining at the time of filing, the attorney must petition the court for payment by the trustee out of the debtor's estate. Pursuant to Bankruptcy Rule 219, the debtor's petition must contain separate disclosure statements for all attorneys' fees paid within a year of filing and for the bankruptcy work itself. The court may examine these disclosure statements and may deny the payment request or order the attorney to reimburse the estate. In either case, the court considers the reasonableness of the fees.

This article outlines the basic procedure used by the bankruptcy and appellate courts to determine reasonable pre-petition attorneys' fees and analyzes the topic under the Code of Professional Responsibility.

Attorneys' Fees in General

Attorneys are prohibited from charging or collecting "clearly excessive fee[s]."[1] The Model Code of Professional Responsibility DR 2–106(A) states that "[a] lawyer shall not enter into an agreement for, charge, or collect an illegal or clearly excessive fee." The American Bar Association has interpreted this Disciplinary Rule in only a few opinions, and in no case has it interpreted this Rule in the bankruptcy context.[2] Furthermore, the ABA, the Maryland State Bar Association, and the local bar associations have published no guidelines for attorneys concerning reasonableness of fees in any situation. In fact, the ABA recommended in 1973 that all state and local bar associations remove "minimum" or "suggested" fee schedules.[3]

In order to limit excessive legal fees, the ABA has recommended that attorneys consider several factors when setting fees.[4] In their review of fee requests, the courts have established additional factors. Basically, two methods are utilized. In *Lindy Brothers Builders, Inc. v. American Radiator and Sanitary Corp.*,[5] the Third Circuit attempted to establish the first set of guidelines for determining the reasonableness of fees. The court used a method commonly known as the "lodestar" method. Reasonableness of the fee petition is determined by ascertaining the attorney's normal billing rate and calculating the amount that would be charged if the rate were multiplied by the number of the attorney's billed hours. The court stated that this calculation is "the only reasonably objective basis for valuing an attorney's services."[6] The figure or lodestar obtained may then be increased or decreased according to the judge's determination of two subsequent factors: the probability of success and the quality of the attorney's work. The judge must consider the risk of failure inherent in the case, weighing such considerations as the outcome of criminal actions against the same defendants and the novelty of the issue. The quality of the attorney's work is determined by the difficulty or complexity of the issues presented, the attorney's ability demonstrated in the courtroom and the recovery obtained.[7] A minority of circuits have utilized this method.[8]

A second method has gained more widespread acceptance. In the seminal case of *Johnson v. Georgia Highway Express, Inc.*, the Fifth Circuit listed twelve factors to be considered in determining fees. They are:

(1) the time and labor required;
(2) the novelty and difficulty of the questions;
(3) the skill requisite to perform the legal service properly;
(4) the preclusion of other employment due to acceptance of the case;
(5) the customary fee;
(6) whether the fee is fixed or contingent;
(7) time limits imposed by client or circumstances;
(8) the amount involved and results obtained;
(9) the experience, reputation and ability of the attorneys;
(10) the "undesirability" of the case;
(11) the nature and length of the professional relationship with the client; and
(12) awards in similar cases.[10]

After weighing the twelve factors, the court will make an award and should explicitly state its reasons for the amount so awarded,[11] so that appellate courts can determine if the trial judge has abused his discretion.[12]

Attorneys' Fees in Bankruptcy

Bankruptcy is possibly the only context in which the court is mandated to protect the client from the attorney. Until the Bankruptcy Reform Act of 1978 was enacted in 1979, bankruptcy cases were governed by the Bankruptcy Act of 1898.[13] Under the 1898 Act, compensation of attorneys was subject to court review under § 60(d) and Rule 220.[14] The Fifth Circuit Court of Appeals utilized that power by extending the *Johnson* analysis to bankruptcy proceedings in *In Re First Colonial Corp.*[15] The inherent sensitivity of bankruptcy proceedings, however, required further economy in awarding attorneys' fees.[16] Thus two variations of the *Johnson* analysis evolved. First, the judge should keep in mind the overriding policy of efficient administration of bankruptcy estates. Since the debtor's attorney does not act in a private capacity but rather as an officer of the court, he should not expect to receive as large a fee as he might in a non-bankruptcy proceeding.[17] The second variation from *Johnson* stems from the court's refusal to award "double compensation"—awarding fees to attorneys who serve the estate in more than one capacity—which was also prohibited by the 1898 Act. The court should determine whether the attorney's application for compensation contains documentation of duplicated efforts in the different capacities.[18] With these policy considerations in mind, the court should then determine the value of the attorney's services in terms of the *Johnson* factors discussed above.[19]

Under the Bankruptcy Reform Act of 1978 (the Code), the emphasis has shifted from giving the judge total discretion to determine reasonable fees to attempting to set a standard that the judge may follow. Under § 330 of the Code, [20] the court must provide notice and hearing and may then award "reasonable compensation for actual, necessary services rendered . . . based on the time, the nature, the extent, and the value of such services, and the cost of comparable services other than in a case under this title."[21] Thus under the Code, an attorney need not expect to receive less in a bankruptcy case than in another case. The customary fees in non-bankruptcy cases become an indicator of reasonable fees in bankruptcy cases. The spirit of economy employed under the 1898 Act is no longer a requirement under the Code.[22]

On August 1, 1983 the New Bankruptcy Rules and Official Forms went into effect. Rule 2016 replaced Rule 219 which governed compensation for services rendered. The new rule is identical to Rule 219, except that the subsection concerning the bases for allowance of compensation has been incorporated into § 330, and the prohibition against sharing compensation has been included in § 504.[23] The substance of the rule, however, has not been altered.

Payments to the Debtor's Attorney

The Code provides in § 547 that a transfer of property of the debtor for an antecedent debt within ninety days of the filing of the bankruptcy petition is a preferential transfer. As such, it is avoidable by the trustee because a debtor is presumed to be insolvent within the ninety-day period and (unless proven otherwise) any transfer of property during that time is presumed to work to the benefit of one creditor and to the detriment of the others. The trustee is therefore given the power to demand return of the property.

The debtor's attorney enjoys a particular confidentiality with the client which may become a breeding ground for misconduct in pre-petition transactions. Congress recognized this problem in Senate Report No. 95–989 when it stated:

> Payments to a debtor's attorney provide serious potential for evasion of creditor protection provisions of the bankruptcy laws, and serious potential for overreaching by the debtor's attorney, and should be subject to careful scrutiny.[24]

Because of their relationship with the client, some attorneys have attempted to circumvent the preference provisions of the Code by obtaining an attorney's lien upon certain assets of the debtor, such as his accounts receivable. As secured creditors, their claim has priority over unsecured creditors. Many courts, however, have avoided these liens as preferential transfers when there is no evidence presented of perfection of the security interest,[25] when the payments are made from funds obtained through litigation performed by the attorney,[26] or when the attorney has knowledge of the impending bankruptcy.[27]

The trustee may not avoid the payment of a debt which is not antecedent, or one which is made during the ninety-day period, if it is made in the ordinary course of business and paid within 45 days of the incurrence of the debt.[28] Thus, payment to the debtor's attorney for bankruptcy-related work is not a preferential transfer and is not avoidable by the trustee. Because of the threat of overreaching as discussed in the Senate Report,[29] Bankruptcy Courts must be careful to protect the assets of the estate from depletion. It may be difficult to detect preferential payments to the attorney since the attorney prepares the petition for the debtor and since the attorney may disguise the payments for non-bankruptcy work as part of the payment for bankruptcy-related matters. The court and the trustee examine payments made during the preferential period to another creditor with greater scrutiny to determine if a fraudulent transfer has occurred. A lighter scrutiny is applied when examining payments to attorneys. Attorneys must affix to the debtor's petition a statement of their fees and any unpaid balance due from the debtor's estate. Under § 329, the court may cancel any agreement for compensation or order the return of any excess payment if such payments are deemed to exceed the reasonable value of such services.

Practical Application of Fee Examinations

The standard for reasonableness, although subject to the *Johnson* or lodestar analysis and § 330, is nevertheless within the judge's sound discretion. In the United

States Bankruptcy Court for the District of Maryland, Baltimore Division, the judge sets an ideal fee for particular types of bankruptcy, and issues a Show Cause order as to why the fee should not be diminished if the amount listed in the petition exceeds the limit the judge has set. The court does not disclose the actual amount of the maximum fees allowable. While this non-disclosure protects some bankruptcy estates from overreaching by the debtor's attorney, it also deprives attorneys of guidelines to determine fair and equitable fees. In fact, this practice promotes litigation by failing to provide scrupulous attorneys with assistance in setting fees and by chastizing them after the fees are set. With the immense number of bankruptcy cases filed each year, there is little chance that each case will be examined to determine if the fees charged are reasonable. If there is no objection to the amount, the court allows the compensation if it does not exceed its limit.

While attorneys have the ethical obligation to charge a reasonable fee,[30] without standards to guide them the task is difficult. There appear to be three standards applied when dealing with attorneys' fees in bankruptcy: the Code of Professional Responsibility, the Bankruptcy Code, and caselaw (such as *First Colonial*). While these standards appear to overlap, it is unclear how they are intended to interact, when they are intended to apply, and which takes precedence. If the court determines that a fee is excessive, should a complaint be filed with the Ethics Committee? If a fee is found to be excessive, is it *per se* unethical? These questions and more need to be answered.

Conclusion

In order to protect unwary clients and to prevent subsequent litigation, the local bar associations should examine attorneys' fees and develop recommendations as to what fees are reasonable. The present standards in DR 2–106 are ambiguous: "[a] fee is clearly *excessive* when, after a review of the facts, a lawyer of ordinary prudence would be left with a definite and firm conviction that the fee is in excess of a reasonable fee."[31] (emphasis added.) Without guidelines, the attorney may, even without so intending, charge a fee that is later considered to be excessive. The reluctance on the part of the bar associations to establish guidelines is an overreaction to the prohibition against fixing clearly improper minimum fees.[32]

In the absence of sufficient guidelines, however, attorneys should take it upon themselves to ascertain reasonable rates in the community and attempt to keep them to a minimum. Although the Code no longer requires economy in fees, the bankruptcy bar should consider it their ethical obligation under DR 2–106 to charge lower-than-normal fees to clients who contract for their services because of financial problems. Rather than remaining silent, creditors should also become more involved by objecting to fees which appear excessive. In many liquidation cases, the amount received by the debtor's attorney for bankruptcy matters may equal half of the amount owed to creditors. These fees, however, do not trigger the court's alarm by exceeding the amount set for liquidation cases. Heightened awareness of the ethical obligation should benefit both the petitioner and the creditor in many bankruptcy cases.

* *Kimberly Armstrong is a third-year law student at the University of Baltimore School of Law who has been working in the area of bankruptcy.*

Footnotes

[1] MODEL CODE OF PROFESSIONAL RESPONSIBILITY DR 2–106 (A) (1979). *See also* EC 2–18 (1979).
[2] *Cf.* ABA Comm. on Professional Ethics, Formal Op. 323 (1970).
[3] *Fee Schedules on the Way Out*, 59 A.B.A.J. 1435 (1973).
[4] MODEL CODE OF PROFESSIONAL RESPONSIBILITY DR 2–106 (B) (1979).
[5] 487 F.2d 161 (3d Cir. 1973); 540 F.2d 102 (3d Cir. 1976) (after remand).
[6] *Id.* at 161, 167.
[7] *Id.*
[8] *Furtado v. Bishop*, 635 F.2d 915, 916 (1st Cir. 1980); *Seigal v. Merrick*, 691 F.2d 161, 164 (2d Cir. 1980); *Chrapliwy v. Uniroyal, Inc.*, 670 F.2d 760 (7th Cir. 1982); *Avalon Cinema Corp. v. Thompson*, 689 F.2d 137, 140 (8th Cir. 1982); *Copeland v. Marshall*, 641 F.2d 880 (D.C. Cir. 1980).
[9] 488 F.2d 714 (5th Cir. 1974).
[10] *Id.* at 717–19.
[11] *Lindy Brothers Builders, Inc. v. American Radiator and Sanitary Corp.*, 487 F.2d 161, (3d Cir. 1973). *See also* Report of the Proceedings of the Judicial Conference of the United States, March 30–31, 1967 at 34 (as cited in Notes of Advisory Committee on Rules, 11 U.S.C. Rule 219, Appendix at 1318 (1976).
[12] 488 F.2d at 717.
[13] 11 U.S.C. §§ 1–1200 (1976).
[14] 11 U.S.C. § 102 (1978); Bankruptcy Rule 219.
[15] 544 F.2d 1298 (5th Cir. 1977), *cert. den.* 431 U.S. 904 (1977).
[16] *Id.* at 1299.
[17] *Id.*
[18] *First Colonial*, 544 F.2d at 1299; 11 U.S.C. §§ 102, 104 (Supp. V 1981); Bankruptcy Rule 219 (1977).
[19] *Id.*, 544 F.2d at 1300.
[20] 11 U.S.C. § 330 (Supp. V 1981).
[21] *Id.*
[22] *See* H.R. Rep. No. 595, 95th Cong., 1st Sess. 330 (1977) reprinted in U.S. Code Cong. & Ad. News 5787, 6286 (1978). *In Re Casco Bay Lines, Inc.* 25 Bankr. 747, 754 (1982).
[23] The only changes in subsections (a) and (b) are stylistic.
[24] S. Rep. No. 989, 95th Cong., 2d Sess. 39 (1978); U.S. Code Cong. & Ad. News 5825.
[25] *In re Peninsula Roofing and Sheet Metal, Inc.*, 9 Bankr. 257 (1981).
[26] *In re Winters and Co., Inc.*, 26 Bankr. 720 (1982).
[27] *In re Pacific Far East Line, Inc.*, 644 F.2d 1290 (9th Cir. 1981).
[28] 11 U.S.C. § 547(6) (Supp. V 1981).
[29] *See* n. 24 *supra*.
[30] MODEL CODE OF PROFESSIONAL RESPONSIBILITY DR 2–106, EC 2–18.
[31] MODEL CODE OF PROFESSIONAL RESPONSIBILITY DR 2–106 (B). *Cf.* ABA Formal Op. 27 (1970).
[32] *Cf.* ABA Formal Op. 171 (1970).

Recent Developments

(continued from page 4)

available in divorce and criminal courts: "The criminal law may vindicate society's interest in punishing a wrongdoer but it cannot compensate an injured spouse for her or his suffering and damages. Divorce or separation provide escape from tortious abuse but can hardly be equated with a civil right to redress and compensation for personal injuries." *Merenoff v. Merenoff*, 76 N.J. 535, 388 A.2d 951, 962 (1978).

Justice Couch, joined by Justice Rodowsky, dissented in *Boblitz*, based on his belief that such a change would be best made by the legislature. The majority held that in the present case there existed no legislative barrier to the abrogation of the doctrine, since it was a common law rule brought about by judicial decisions. The court further stated that the doctrine of *stare decisis* should not be construed as a prohibition against changing a rule of law that has become unsound in the circumstances of modern life.

While the decision in *Boblitz* may be viewed as a giant step forward in Maryland tort law, there are circumstances in which the interspousal immunity rule may still apply. The court stated that certain conduct that would be tortious between strangers would not be tortious between spouses due to the mutual concessions implied in the marital relationship. The doctrine of intra-family tort immunity was untouched by the *Boblitz* decision. The court also limited its holding to cases sounding in negligence and did not address cases which involved intentional torts.