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THOMSON WEST

THE USE OF A BUSINESS TRUST AS A SPECIAL PURPOSE VEHICLE: SOME BANKRUPTCY IMPLICATIONS

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Structured finance transactions frequently involve the use of a bankruptcy remote entity, also known as a special purpose vehicle ("SPV"). Traditionally, the entity establishing the SPV transfers assets to the SPV in exchange for securities issued by the SPV, which are then directly or indirectly sold in the public or private securities markets. The "parent" often retains some of the SPV's securities. Even so, because the SPV structure contains numerous protections against insolvency and bankruptcy risks of the

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"parent" entity that establishes the SPV, the SPV's securities can enjoy a higher rating than the one available to the "parent."

The SPV is often a corporation or a limited liability company. When, however, tax considerations mandate that the SPV qualify as a grantor trust for tax purposes, the use of a corporate or limited liability company SPV will not do. A business trust can often be used instead to accomplish the sought after tax treatment. But will a business trust provide sufficient protection for purchasers of the securities against the risk of a bankruptcy or insolvency of the "parent?"

A statutory Delaware business trust can provide comparable protection to the ones associated with a corporate or limited liability company SPV, because the Delaware business trust statute makes clear that the business trust is a separate legal entity and has essentially all of the attributes of a corporation. In certain circumstances, however, parties may wish to utilize a common law trust in order to minimize the costs and formalities. For example, the Delaware statute requires the appointment of at least one Delaware trustee, rather just a local trustee under the law governing the trust agreement. In addition, the use of a common law trust preserves for litigation the argument that the trust is not eligible for bankruptcy. Under the circumstances, if an ordinary business trust could provide sufficient protection against bankruptcy and insolvency risk, parties could achieve the dual goal of having the SPV qualify as a grantor trust for tax purposes and provide the same level of "bankruptcy protection" as do traditional corporate and limited liability company SPVs. See 11 U.S.C. § 101(9)(A)(v) (for purposes of the Bankruptcy Code the term "corporation," includes only a business trusts, not testamentary trusts); **Shawmut Bank v. First Fidelity Bank (In re Secured Equipment Trust of Eastern Air Lines, Inc.),** 38 F.3d 86 (2d Cir. 1994) (trust held not to be an eligible debtor) (Norton Bankr. L. & Prac. 2d § 9:8; Bankr. Serv., L Ed §§ 12:226, 12:240).

To do so, it must be clear that in the event of a "parent" bankruptcy, the underlying trust's assets will not be treated as property of the "parent's" bankruptcy estate and that the "parent's" creditors will not be able to reach the trust property directly, whether or not the "parent" retains a beneficial interest in the trust. In our view, a common law business trust should meet these requirements. [See Norton Bankr. L. & Prac. 2d §§ 87:15-85:25; West's Key Number Digest, Bankruptcy ⚷ 3025-3026, 3035-3039, Joint-Stock Companies and Business Trusts 1, 6-9, 10, 11, 13, 14, 15(1, 15(2), 18, Taxation 114.]

Types of Trusts

A trust may be a private trust, a common law or statutory business trust, or a Massachusetts-type nominee or Illinois-type land trust. See 76 AM. JUR. 2d, Trusts, ¶ 11. Although the lines between a private trust that might be engaged in some form of business and a business trust can blur, a nominee or land trust is clearly distinct from either.

Nominee Trusts and Land Trusts

The beneficial owner of a nominee or land trust has essentially complete control over the trustee's actions and management of the trust, is entitled to the proceeds generated by the trust's assets, and may terminate the trust at will. As such, the beneficiary of one of these trusts is deemed to be the direct equitable owner of the trust res, at least when the trust is owned 100% by the debtor or beneficial owner, and the trust's assets are subject to administration in the bankruptcy of the beneficiary. See **In re Simon,** 179 B.R. 1 (Bankr. D. Mass. 1995) (Bankr. Serv., L Ed § 29:512); **In re Eastmare Dev. Corp.,** 150 B.R. 495 (Bankr. D. Mass. 1993) (Bankr. Serv., L Ed §§ 19:339, 29:285); **In re Ameriswiss Assocs.,** 148 B.R. 349 (Bankr. S.D. Fla. 1992) (Bankr. Serv., L Ed § 29:246); **In re Ainslie & Belle Plaine Ltd. Partnership,** 145 B.R. 950 (Bankr. N.D. Ill. 1992) (Bankr. Serv., L Ed § 29:254). The business trusts utilized in structured finance transactions do not include these elements of control, management or termination and therefore would not be nominee or land trusts.

Business Trusts and Private Trusts

A private trust is "one used to effect a gift or transfer of property." **In re Gurney's Inn Corp. Liquidating Trust,** 215 B.R. 659, 661 n.2 (Bankr. E.D. N.Y. 1997) (Bankr. Serv., L Ed §§ 12:226, 12:229, 12:239, 12:1073, 12:1077, 30:6, 30:122); **Plymouth Secs. Co. v. Johnson,** 335 S.W.2d 142, 149 (Mo. 1960). Case law is split as to whether the trust's eligibility to file for bankruptcy is controlled by state or federal law. **Gurney's Inn,** 215 B.R. at 661-62. The category of private trusts includes numerous sub-categories, such as family estate trusts, gift tax trusts, living trusts, support trusts, etc. Although a private trust may carry on a business, it is not necessarily a business trust. **In re Hughes Living Trust,** 305 B.R. 59 (Bankr. W.D. Okla. 2004).

By contrast, a business trust is an entity that provides "a medium for the conduct of a business and the sharing of its gains." **Denmark Cheese Ass'n v. Hazard Advertising Co.,** 298 N.Y.S.2d 98, 100 (N.Y. App. Div. 1969), order modified on other grounds, 305 N.Y.S.2d 1019 (N.Y. App. Div. 1969) (citing **Continental Bank & Trust Co of New York v. United States**, 19 F. Supp. 15, 18 (S.D.N.Y. 1937).) A business trust is "an entity used to make profit (directly or indirectly)." **Gurney's Inn,** 215 B.R. at 661 n.2; **Denmark Cheese,** 298 N.Y.S.2d at 100. It is "a device whereby to gain substantially all the advantages of incorporation and to escape the disadvantages of legislative regulation." **Brown v. Bedell**, 263 N.Y. 177, 186, 188 N.E. 641 (1934). It is the similarity of the trust to a corporate entity that makes it a business trust. **Hughes,** 305 B.R. at 59 (citing **In re Treasure Island Land Trust**, 2 B.R. 332, 334 (Bankr. M.D. Fla. 1980).) (Norton Bankr. L. & Prac. 2d §§ 75:2, 76:2; Bankr. Serv., L Ed §§ 12:4, 12:7, 12:135, 12:217, 12:229, 12:232, 12:237).

A business trust is not, strictly speaking, a trust. The Restatement excludes business trusts from its scope.

> Although wearing the guise of a trust, the Massachusetts or business trust is essentially a business device, as is shown by its exclusion from the Restatement of the Law of Trusts. Initially it offered investors many of the advantages of corporations, yet avoided some of the restrictions and limitations attached to corporations.

RESTATEMENT (SECOND) OF TRUSTS, § 1, cmt. (b) (1959). See also Herbert B. Chermside, Jr., Annotation, *Modern Status of the Massachusetts Business Trust,* 88 A.L.R.3d 704, 711 (1978 & 2003 Supp.) ("**Annotation**").

Instead, "it is a hybrid of various forms of for-profit business organizations with characteristics gleaned from private trusts." **Loux v. Gabelhart (In re Carriage House, Inc.)**, 120 B.R. 754, 763 (Bankr. D. Vt. 1990), aff'd, 146 B.R. 352 (D. Vt. 1992) (Norton Bankr. L. & Prac. 2d § 51:14; Bankr. Serv., L Ed § 29:512). A business trust is more akin to a corporation. See **In re Secured Equip. Trust of Eastern Air Lines, Inc.,** 38 F.3d at 89; **In re Morgantown Trust No. 1,** 155 B.R. 137, 143 (Bankr. N.D. W. Va. 1993) (quoting **In re Armstead & Margaret Wayson Trust**, 29 B.R. 58, 59 (Bankr. D. Md. 1982)) (Norton Bankr. L. & Prac. 2d § 76:2; Bankr. Serv., L Ed §§ 12:226, 12:234, 12:1074, 12:1079); **Carriage House,** 120 B.R. at 763. As a result:

> It is well settled that certificate holders in a conventional common-law trust stand in their relation to the trust much as do stockholders to a corporation. In ordinary circumstances, they are not creditors of the trust. Instead, they are equitable owners of proportional interests in the trust property.

Selected Inv. Corp. v. Duncan, 260 F.2d 918, 921 (10th Cir. 1958) (citing **Bryan v. Welsh**, 72 F.2d 618, 620 (10th Cir. 1934)); **Dvinsky v. Cook (In re Cook),** 104 F.2d 981, 984 (7th Cir. 1939); **Annotation,** 88 A.L.R.3d 704, ¶ 2 at 713, ¶ 21 at 738.

The common law elements of a business trust include an intent to create a business trust, a business purpose of acquiring, holding and selling property, the contribution of property as the capital of the trust, the trustee's acquisition of title to the property in the capacity of trustee, the limitation on the trustee's liability, the express statement of powers and duties of the trustee to the trust and the beneficiaries, and the beneficiaries' entitlement to demand the issuance of certificates of shares of beneficial ownership in the trust. **Carriage House,** 120 B.R. at 764. The "trustee's acquisition of title" played a key role in the cases in determining whether the contribution of property for a business purpose by a group of individuals created a business trust or a partnership. **Carriage House,** 146 B.R. at 356-57 (citing cases); **Annotation,** 88 A.L.R.3d 704, ¶ 7. If the "managers" of the property took title to and owned the underlying property and had complete control over it, they were considered trustees of a business trust, but if they acted as agents for the investors, subject to the investors' control and direction, the investor group would be treated as a partnership. **Brown v. Bedell,** 263 N.Y. at 187-88. These cases adopted this "control test" as determinative of the existence of a business trust rather than a partnership. 13 AM. JUR. 2d, Business Trusts, ¶ 11; **Annotation,** 88 A.L.R.3d 704, ¶ 8. The "business purpose" element has been less clearly defined. Although a business purpose is required, it remains unsettled whether that includes the operation of a business or the existence of a profit-making motive as a required element. Some of the cases have included business operation or profit-making motive among the elements mentioned. **Secured Equip. Trust,** 38

F.3d at 90; **Gurney's Inn,** 215 B.R. at 661 n.2. In only one, however, was the presence or absence of either of these factors determinative in the decision. **Denmark Cheese Assn. v. Hazard Adv. Co.**, 33 A.D.2d 761, 305 N.Y.S.2d 1019 (N.Y. App. Div. 1969). Thus, a trust whose sole purpose is to receive and hold a business investment for its beneficiaries should qualify as a business trust. For example, section 9-1.5 of the New York Estate, Powers and Trust Law, provides:

> This section applies to an investment trust, which is an unincorporated trust or association managed by trustees not holding any property for sale to customers in the ordinary course of its trade or business, the beneficial ownership of which is evidence[d] by transferable shares or by transferable certificates of beneficial interest offered for sale to the public.

N.Y. Est. Powers & trusts § 9-1.5. Such a trust is likely a business trust, as opposed to a private trust. See Governor's Memorandum, 1961 Session Laws of New York, 2101. Yet it qualifies as such despite the requirement that the trust not conduct business.

Some states have enacted legislation regulating business trusts, which codifies and incorporates these common law aspects of a business trust. Under the Delaware statute, a business trust is an unincorporated association, created by an instrument under which property is administered, invested, controlled or operated, or business or professional activities are conducted for profit, carried on by the trustees for the beneficiaries' benefit, including common law business trusts. Del. Code Ann. tit., 12, § 3801(a). New York law defines a business trust as "any association operating a business under a written instrument or declaration of trust, the beneficial interest under which is divided into shares represented by certificates." N.Y. Gen. Ass'ns Law § 2(2) (McKinney 1994). This provision provides the grant of authority to business trusts and joint stock associations to conduct business in New York and to sue and be sued in New York courts upon the filing of a certificate with the Secretary of State. It appears to have been enacted in response to **Burgoyne v. James,** 282 N.Y.S. 18 (N.Y. App. Div. 1935), aff'd, 284 N.Y.S. 977 (N.Y. 1935), which held that a foreign business trust was not a foreign corporation for purposes of having to obtain a certificate of authorization to do business in New York and sue in the New York courts, and which invited the legislature to amend the General Corporation Law to change the result. It is thus unclear whether the provision constitute a general definition of "business trust" for all purposes under New York law, including the common law of business trusts.

Treatment of Business Trusts in Bankruptcy

Property of the Estate

All of the debtor's interests in property become property of the debtor's estate upon the debtor's filing of a bankruptcy petition. See 11 U.S.C. § 541(a)(1). It becomes property of the estate, however, only to the extent of the debtor's ownership interest in the property. **McGahren v. Heck (In re Weiss),** 111 F.3d 1159, 1167 (4th Cir. 1997) (Norton Bankr. L. & Prac. 2d § 79:21; Bankr. Serv., L Ed §§ 29:27, 29:62, 29:200, 29:201, 36:270, 36:281, 36:282, 58:290, 58:295, 58:346, 58:352, 58:362, 59:207, 59:209, 59:210, 59:217, 59:225, 59:288, 59:295, 59:300, 59:302); **In re Squyres,** 172 B.R. 592, 594 (Bankr. C.D. Ill. 1994) (Bankr. Serv., L Ed § 29:406). Thus, it is basic that property of a corporation in which the debtor is a stockholder, even the sole stockholder, does not become property of the debtor's estate, because the debtor does not own the underlying corporate assets. **Feldman v. Trustees of Beck Indus., Inc. (In re Beck Indus., Inc.),** 479 F.2d 410, 415-16 (2d Cir. 1973); **Regency Holdings (Cayman), Inc. v. The Microcap Fund, Inc. (In re Regency Holdings (Cayman), Inc.),** 216 B.R. 371, 375 (Bankr. S.D.N.Y. 1998) (Bankr. Serv., L Ed §§ 29:32, 33:110, 33:111, 33:121). Partners also do not have a direct ownership interest in partnership property, so partnership property does not become property of a partner's estate. **In re Weiss,** 111 F.3d at 1166. Similarly, "The interests of the stockholders in the assets of [a joint stock] association are analogous to that of the stockholders in a corporation," **Hibbs v. Brown**, 98 N.Y.S. 353, 357 (N.Y. App. Div. 1906), aff'd, 82 N.E. 1108 (N.Y. 1907); and should not become property of the estate of the stockholder. See **In re General Teamsters, Warehousemen & Helpers Union Local 890,** 225 B.R. 719 (Bankr. N.D. Cal. 1998) (bankruptcy of an association did not involve assets of members of the association) (Bankr. Serv., L Ed §§ 12:1109, 29:353, 29:414, 45:87, 45:92, 45:130, 45:377, 45:389, 45:431, 45:433, 45:437).

Common law authorities dealing with a failed attempt to create a business trust typically classify the resulting entity as a partnership, **Carriage House,** 146 B.R. at 356-57; **Annotation,** 88 A.L.R.3d 704, 725, § 7, or as unincorporated joint stock associations. **Annotation,** 88 A.L.R.3d 704, § 10, at 728-29. Therefore, similar principles of separation should apply to a business trust. Otherwise, only a successful effort to create a business trust would eliminate separation, the very result the parties to the creation of a business trust seek to prevent. When the business trust is organized under Delaware law, the Delaware statute specifically provides that the holders of the beneficial interests in the trust do not own the underlying trust res. DEL. CODE ANN. TIT., 12 § 3805(b) & (c).

Thus, the bankruptcy of the holder of a beneficial interest in an irrevocable business trust should have no effect on the trust, its corpus, its creditors, or its other beneficial holders. The courts appear to have uniformly adopted that principle. What is more, they have applied the principle to private trusts as well as to business trusts. The clearest application of this principle involved a trust established by a husband to hold business real property. The husband was the settlor, trustee and owner of a 50% beneficial interest in the trust. The wife owned the remaining 50% interest. When the husband and wife both filed bankruptcy, they sought to claim the real property as property of their estate, on the ground that the trust did not qualify as a business trust. Nevertheless, the court ruled that regardless of whether the trust qualified as a business trust under the Vermont statute, the underlying realty was not property of the debtors' estate. **In re Carriage House, Inc.**, 120 B.R. 754 (Bankr. D. Vt. 1990), aff'd, 146 B.R. 352 (D. Vt. 1992).

Another court reached the same result where the nature of the trust was also unclear. The husband debtor was the settlor, the husband and the wife debtor were co-trustees, but only the wife was the beneficiary of a trust that owned real estate subject to mortgages executed by the debtors as trustees on behalf of the trusts. The court ruled that the trust was not a nominee trust and that "the properties were not owned by the Debtors, did not constitute 'property of the estate,' and only [the wife] had an equitable interest in the Trust properties that constituted intangible personal property." **Lyons v. Federal Sav. Bank (In re Lyons),** 193 B.R. 637, 645 (Bankr. D. Mass. 1996).

Courts have reached the same result even when the trust is clearly a private, nonbusiness trust. For example, a debtor may not claim a homestead exemption in a house owned by a trust, because the debtor does not own the house; the trust does. The debtor owns a personal interest in the trust, but that personal (rather than real) property interest cannot provide a basis for a homestead exemption. **In re Bowers,** 222 B.R. 191, 192-93 (Bankr. D. Mass. 1998). Similarly, a debtor's remainder interest in a testamentary trust may become property of the estate, but where the debtor was the trustee and the owner of only a 50% beneficial interest, the trust doctrine of merger of the legal and equitable estates did not apply, so the underlying trust res itself did not become the property of the debtor's bankruptcy estate. **Mann v. Kreiss (In re Kreiss),** 72 B.R. 933 (Bankr. E.D. N.Y. 1987) (Norton Bankr. L. & Prac. 2d § 51:14; Bankr. Serv., L Ed §§ 29:449, 29:512, 29:545). Under the doctrine of merger, if the trustee and the sole beneficiary are the same legal entity, the legal and equitable trust estates merge, and the trustee/beneficiary becomes the outright owner of all interests in the underlying trust property. See RESTATEMENT (SECOND) OF TRUSTS, § 341(1).

Our research has not identified any cases in which a court has determined that the res of an irrevocable trust became property of the debtor beneficiary's estate, except where the legal and beneficial interests were wholly owned by the same entity so that the doctrine of merger applied. See, e.g., **Avery Fed. Sav. & Loan Ass'n v. Klayer (In re Klayer),** 20 B.R. 270 (Bankr. W.D. Ky. 1981) (self-settled trust) (Bankr. Serv., L Ed §§ 29:285, 29:532). Although the facts of many of the cases involved private rather than business trusts, the result should be the same in the business trust context. The distinction between the beneficiaries of a business trust and the trust itself appears stronger and clearer than the distinction in the private trust context, as noted by the Restatement and the Annotation.

The Bankruptcy Code seems to support this result in bankruptcy. A business trust may be a debtor under the Bankruptcy Code. See 11 U.S.C. §§ 101(41) (definition of "person" includes "corporation"), 101(9) (definition of "corporation" includes "business trust"), 109 (a person may be a debtor). A traditional private trust may not. **In re Medallion Realty Trust,** 103 B.R. 8, 10 (Bankr. D. Mass. 1989), aff'd, 120 B.R. 245 (D. Mass. 1990) (Bankr. Serv., L Ed §§ 12:215, 12:1073, 12:1074, 12:1078). See also 11 U.S.C. § 101(15) (definition of "entity"). If, for bankruptcy purposes, a business trust's res is owned by the holders of the beneficial interests in the trust, then the estate of a business trust debtor would not include any property. Thus, the Code's policy appears to treat the property of a business trust as separate from the property of the beneficial owners of the trust. Courts dealing with private trusts have clearly reached the same result, even though a private trust is not eligible to be a debtor.

Trustee's Avoiding Powers

The Bankruptcy Code gives a bankruptcy trustee the power obtain property not owned by the debtor if, under applicable nonbankruptcy law, a contract creditor of the debtor could obtain a judicial lien on the property. See 11 U.S.C. § 544(a). Thus, if a creditor of a owner of a beneficial interest in a trust could obtain a judicial lien on the trust property itself, then the property could be brought into the bankruptcy estate through this power. The question is strictly an issue of nonbankruptcy law, typically state law, and traditional enforcement of judgments law must be consulted to determine the extent of the rights of a creditor of the beneficiary.

The principle of separateness denies creditors the right to obtain judicial liens on trust property where the debtor holds only a beneficial interest in the trust. The Supreme Court addressed this issue in a case involving an entity that had all of the characteristics of a business trust, although the Court treated it as a partnership:

> The proceedings for this purpose assume that the share of the judgment debtor in the association is an interest in the lands; and though legal title be in the trustees, is liable to be seized on the execution and sold, and the purchaser put in possession. The settled law is otherwise.

See **Clagett v. Kilbourne,** 66 U.S. (1 Black) 346, 348-49, 17 L. Ed. 213 (1861) (judgment creditor sought the wrong remedy because the debtor's interest in the trust was personalty, not realty).

Other courts have reached the same result. **In re Pittsburg Wagon Works' Estate,** 54 A. 316 (Pa. 1903) (execution sale against real estate held in trust in which judgment debtor held a beneficial interest was ineffective to pass title to the judgment creditor); **Horney v. Hayes,** 142 N.E.2d 94 (Ill. 1957) (assignment of a certificate of a beneficial interest in a land trust as security for a loan does not constitute a mortgage of real estate); **Lawn Sav. & Loan Ass'n v. Quinn,** 225 N.E.2d 683 (N.Y. App. Div. 1967) (foreclosure on trust certificate does not transfer interest in the underlying real estate; Illinois land trust); **Annotation,** Massachusetts or Business Trusts, 156 A.L.R. 22, 88 (1945) ("The trust estate cannot ordinarily be directly reached by a creditor of an individual shareholder.").

The rule, however, is not absolute and will not be applied where necessary to prevent fraud. For example, where the trust was essentially a sham, and the legal and equitable interests were united in the defendant, the court allowed creditors of one of the certificate holders to look to the trust's property. **Cunningham v. Bright,** 117 N.E. 909 (Mass. 1917). Certain Delaware cases involving nonbusiness trusts have permitted creditors to reach the underlying trust res because the debtor was the sole beneficiary or the settlor/sole beneficiary. R. Franklin Balotti & Jesse A. Finkelstein, Delaware Law of Corporations and Business Organizations ¶ 19.4 (3d ed. 1998) (citing **Security Trust Co. v. Sharp**, 77 A.2d 543 (Del. Ch. 1950) (spendthrift trust); **Weymouth v. Delaware Trust Co.,** 45 A.2d 427 (Del. Ch. 1946) (inter vivos trust); **H.M. Byllesby & Co. v. Doriot,** 12 A.2d 603 (Del. Ch. 1940) (voting trust)). These cases are consistent with the doctrine of merger, discussed above.

Conclusion

Use of a common law business trust in synthetic securities transaction, without the formalities and statutory explicitness of a Delaware business trust, appears to provide protection against depositor bankruptcy risk where the depositor does not retain all of the beneficial interests in the trust. A transfer of the underlying assets to a business trust SPV should insulate the trust assets from the creditors of the depositor and from a trustee or debtor in possession in a depositor bankruptcy, as well as use of a corporate or limited liability company SPV. In structuring the transaction, however, attention should be given to true sale, substantive consolidation and fraudulent transfer considerations.

BETWEEN THE CHARYBDIS OF *BIGGAR* AND THE SCYLLA[1] OF *LAMIE*: HOW CAN A DEBTOR'S LAWYER GET PAID?

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On January 26, 2004 the United States Supreme Court decided **Lamie v. United States Trustee,** ___ U.S. ___, 124 S. Ct. 1023, 157 L. Ed. 2d 1024 (2004), holding that a Chapter 7 debtor's attorney may not be compensated out of property of the estate. The Court concluded that the deletion of the reference to debtors' attorneys in the 1994 revision of 11 U.S.C. § 330(a)(1), while possibly a "scrivener's error," nevertheless had to be interpreted strictly and literally; that section permits an attorney appointed to represent a bankruptcy estate to be paid out of the estate, but not lawyers who are not court approved to represent debtors in ordinary Chapter 7 cases. [See Norton Bankr. L. & Prac. 2d § 26:5, West's Key Number Digest, Bankruptcy 🔑 3029-3031; Bankr. Serv., L Ed §§ 1A:62, 1A:102.]

In **Lamie,** the attorney started out representing the debtor in a Chapter 11 case. Some three months into Chapter 11, the case was converted to Chapter 7. The debtor's attorney continued to provide legal services to the debtor but did not seek appointment to represent the estate.

The debtor's attorney filed an application for compensation incurred representing the debtor in the Chapter 7 proceeding. The United States Trustee objected, arguing that the funds at issue were property of the estate and could not be paid to the attorney because § 330(a)(1) does not include debtors' attorneys in the list of professionals who may be paid out of the estate.

The debate in **Lamie** turned largely on the question whether the deletion from § 330 of the reference to debtors' attorneys in the Bankruptcy Reform Act of 1994 was a mere "scrivener's error," or a deliberate legislative act to exclude debtors' attorneys from being paid? Looking at legislative history, the **Lamie** court could not discern clear legislative intent either way, and therefore fell back on the maxim of statutory interpretation: the "plain language" of the statute controls.

Consumer bankruptcy attorneys reading **Lamie** may mistakenly dismiss it as a case affecting only lawyers applying to be paid in reorganization cases, or complex asset Chapter 7 cases, where the estate is holding sizable funds and there are messy issues. Those lawyers would be in for a surprise. The ruling in **Lamie** probably affects a majority of consumer bankruptcy attorneys filing relatively simple Chapter 7 cases, and could be a ticking time-bomb of potential disgorgement orders.[2]

In the ordinary consumer bankruptcy case, an attorney who collects a retainer fee prepetition, a portion of which is intended to pay for the attorney's postpetition services, is holding property of the estate as of date of filing.[3] **Lamie** says that unless appointed to represent the estate the attorney may not be paid out of the retainer funds, but must turn them over to the trustee. Several surveys of fees practices among the debtors' bar indicate that a majority of consumer bankruptcy attorneys collect fees in this fashion, weather as fixed fees or as deposits against hourly fees.[4]

In jurisdictions that require the attorney of record on the petition to represent the debtor for routine postpetition administrative tasks—such as attendance at the 341 meeting, counseling in connection with reaffirmation agreements, and preparing and filing such amended schedules as may be needed—the attorney may end up performing these services for free. If the attorney cannot be paid out of the balance of a prepetition retainer fee allocated for postpetition services, the retainer must be surrendered to the estate or to the client. Only new funds from the debtor could be used to refuel the retainer after the petition. Most case authority holds that there is nothing wrong with collecting postpetition money from the debtor to pay for postpetition services.[5] However, counsel must be careful to assure that such funds are not, property of the estate. This could happen, for example, where the debtor pays the postpetition fees out of funds received postpetition but for which the debtor had a right to payment prior to filing (such as accounts receivable in a small business), or generated the funds from property that was property of the estate (e.g., rental income), or simply had them sitting in a bank account unprotected by an exemption.

Prior to **Lamie** some courts held that, even though the held-over portion of the retainer fee is property of the estate, the attorney may be paid from such funds for handling the routine postpetition administrative tasks.[6] As sensible as this may seem, a strict reading of **Lamie** rules it out. Under this practice, a portion of the fee collected prepetition must be presumed to be allocated to cover the 341 meeting; under **Lamie** those funds cannot be paid to the attorney.

But the predicament is even worse for a consumer Chapter 7 case that has postpetition problems, because the attorney cannot hide behind the argument that payment for administrative tasks is necessary to administer the case. For one thing, many postpetition tasks serve to protect the debtor rather than the estate. How does the attorney protect payment of fees for a tug-of-war with the trustee over exemptions, motions for relief from stay (yes, they do happen in Chapter 7), arguments over valuation for redemption, judgment lien avoidance motions, adversary complaints to determine dischargeability, and other similar non-administrative tasks?

The vast majority of such cases are no-asset cases, with no money in the estate to argue over. But under **Lamie,** what looks like a no-asset case may suddenly become one: The easily overlooked asset is the portion of the prepetition fee held by the attorney to cover postpetition services.

An argument can be made that **Lamie** was not well presented, resulting in bad law. In oral argument before the Court, the Government represented to the Court that after the petition, or following conversion to Chapter 7, the trustee more or less takes over and there is nothing left for the debtor's attorney do to. The Government's attorney stated several times, "In a Chapter 7 case, the bulk of the work is done prepetition. It's advising the debtor about which Chapter to file, filling out the schedules, telling the debtor what property is exempt, and so forth … . In Chapter 7, unlike all other cases, it is the trustee and not the debtor who manages, represents and liquidates the estate … . Once it converts to Chapter 7, then it's the trustee's job to take over … . And what will happen, … is when cases convert, the debtor's counsel will cease performing work unless the trustee actually gets a court order approving their retention."[7]

If the Supreme Court bought that argument, it was misinformed about the practicalities of consumer bankruptcy and the role of the debtor's attorney. Any lawyer who has handled consumer bankruptcy cases will attest, there is frequently plenty to do after the case is filed or converted from another Chapter.[8]

The **Lamie** court acknowledged the argument that failure to compensate debtors' counsels out of property of the estate would "lead to a departure from the principle of prompt and effectual administration of bankruptcy law." In response the Court stated that debtors' attorneys could still be compensated under the Code, saying "compensation remains available to debtors' attorneys through various permitted means." **Lamie,** 124 S. Ct. at 1031. But the Court did not explain what these "means" were. The examples given in the opinion widely missed the mark. The Court observed that debtors' attorneys can be paid for their work in Chapter 13 under § 330(a)(4)(B) and the Code permits trustees to engage attorneys. Not much help for debtors' counsel in Chapter 7 cases.

As further justification the Court quoted a *Collier* publication for the proposition that, "[i]n the majority of cases, the debtor's counsel will accept an individual or a joint consumer Chapter 7 case only after being paid a retainer that covers the 'standard fee' and the cost of filing the petition." The Court remarked, "[s]o our interpretation accords with common practice." **Lamie,** 124 S. Ct. 1032. In fact, surveys show that this is probably not the predominant practice, but rather the opposite—most attorneys collect enough prepetition to carry them past filing and into anticipated postpetition tasks. The survey cited above showed that only 18% of consumer bankruptcy attorneys collect a prepetition fee only intended to cover services up to point of filing. The **Lamie** examples of "means" fail to address the real issue: How do Chapter 7 debtors' attorneys get paid for services provided after filing the petition?

In the opposite ditch are those attorneys who do not collect a substantial fee before filing but instead collect a prepetition fee sufficient to cover a portion, but not all, of the prepetition services. These attorneys anticipate collecting the balance of the fee postpetition. However, it is becoming clear from recent cases that the unpaid balance the client owes the attorney on date of filing is discharged. The attorney violates the automatic stay and the discharge injunction by attempting to collect fees after the case is filed.[9] The survey cited above shows that approximately 12% of consumer bankruptcy attorneys collect fees in this fashion.[10]

So, the attorney who collects a fee that is too little, on the one hand, or too much, on the other, is at risk of losing a lot of money or buying a lot of trouble. The only safe option is to assure that the client is paid up and current for all services up to the moment of filing, but not a dime more. In fact, this appears to be the practice for approximately 18% of consumer bankruptcy attorneys.[11]

But even these lawyers face a dilemma. If not collected before filing the petition, how does the attorney get paid for the ordinary postpetition administrative tasks normally expected of the debtor's attorney in consumer bankruptcy cases, or for the extraordinary tasks, such as contested and adversary proceedings?

If the fees are not collected prepetition, to be paid for postpetition work the attorney must look to the debtor for payment after the case is filed. As stated above, there is nothing wrong with collecting fees postpetition to pay for postpetition services, as long as those funds are not property of the estate.[12] But what happens if the debtor cannot, or will not pay, and yet expects the attorney to complete the representation through the end of the case? What if the Court expects it? Can the attorney walk away from the case?

There is authority that once the attorney's name appears on the filed petition, the attorney of record is on the hook for at least the ordinary postpetition administrative tasks.[13] And, Chapter 7 trustees are admonished to consider demanding disgorgement of fees of an attorney who fails to appear at the 341 meeting.[14] Some cases deal with what are sometimes called "limited engagement" retainer agreements, or "unbundling" fee agreements. These agreements purport to limit the level of services to be provided and hence limit the cost of obtaining a bankruptcy discharge. According to the fee practices survey cited above, 51% of the responding lawyers report that such agreements are permitted in their jurisdictions. The few cases that mention such agreements express disapproval. Unfortunately the survey did not ask the precise question: In Chapter 7 cases does local practice permit splitting off any or all postpetition services, including attendance at the 341 meeting?

These obstacles to getting paid will discourage competent attorneys from representing debtors in consumer bankruptcy cases, reducing the quality of services, just when the U.S. Trustee's office is expressing concern over what it perceives to be the mediocre quality of debtor representation. The *Handbook for Chapter 7 Trustees*, prepared by the Office of the U.S. Trustee, states that one of the principal duties of trustees is to act "in the public interest to promote the efficiency and to protect and preserve the integrity of the bankruptcy system." It is fair to say that preserving the integrity of the bankruptcy system includes encouraging, not discouraging, excellence in legal representation of consumer debtors. The efficient and honest functioning of the bankruptcy system requires a robust, competent and motivated debtors' bar.

The system cannot have it both ways. Finding and inventing devices to prevent lawyers from being paid will not encourage excellence in the practice of law. All participants in the system should undertake to help craft legal and practical ways to compensate lawyers for their work on behalf of consumer debtors.[15]

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1. Charybdis was a sea-monster, who thrice a day drew up the water of the sea and then spouted it again, thus forming a whirlpool. She was on one side of the narrow Strait of Messina between Sicily and Italy, and on the other side was Scylla, another sea-monster. The two sides are so close to each other that an arrow could be shot across them. So sailors, on trying to avoid Charybdis became the victims of Scylla and vice versa.
2. The *Handbook for Chapter 7 Trustees* prepared by the Office of the U.S. Trustee provides, "The trustee should be alert for retainers held by debtors' attorneys. While courts generally hold that an unearned retainer on hand at the commencement of a case constitutes estate property, the trustee may have to initiate action to obtain the balance of the retainer." U.S. DEP'T OF JUSTICE UNITED STATES TRUSTEE PROGRAM, HANDBOOK FOR CHAPTER 7 TRUSTEES, CH. 6 (1998) (the entire text of the Handbook may be found at http://www.BankruptcyMedia.com under "LIBRARY").
3. **United States Trustee v. Garvey, Schubert & Barer (In re Century Cleaning Serv., Inc.),** 195 F.3d 1053 (9th Cir. 1999) (abrogated by, **Lamie**) (Norton Bankr. L. & Prac. 2d § 26:5; Bankr. Serv., L Ed §§ 16:21, 16:22, 16:621, 16:622, 16:626, 16:966, 16:1142, 16:1147, 32:45); **Rajala v. Hodes (In re Hodes),** 289 B.R. 5 (D. Kan. 2003) (Bankr. Serv., L Ed §§ 16:578, 16:609, 16:966, 16:978, 16:1144, 16:1145, 16:1146, 16:1148, 24:577, 58:335, 58:349, 59:653); **Meeks v. Perroni (In re Armstrong),** 234 B.R. 899 (Bankr. E.D. Ark. 1999) (Norton Bankr. L. & Prac. 2d § 27:17; Bankr. Serv., L Ed §§ 16:1148, 29:35, 29:335, 29:336, 39:337, 33:195, 33:218, 33:769, 34:238, 34:241, 34:336, 34:373); **In re Friedland,** 182 B.R. 576 (Bankr. D. Colo. 1995) (Norton Bankr. L. & Prac. 2d § 26:5) (disapproved of by, **In re Jones,** 236 B.R. 38 (D. Colo. 1999)).
4. A recent online survey of consumer bankruptcy attorneys conducted by the author, through *The Consumer Bankruptcy Letter*, received responses from attorneys in 35 states. The responses indicated that 71% collect a prepetition retainer fee sufficient to pay for both prepetition services and foreseeable postpetition services. The complete survey may be found at http://www.BankruptcyMedia.com; click on "The Consumer Bankruptcy Letter," then select "Surveys."
5. It is generally acknowledged that an attorney may collect money postpetition from the debtor, to pay for postpetition services. **Sanches v. Gordon (In re Sanchez),** 241 F.3d 1148 (9th Cir. 2001) (Bankr. Serv., L Ed §§ 16:702, 19:706, 19:1429, 19:1493); **Knutson v. Tredennick (In re Tredinnick),** 264 B.R. 573 (B.A.P. 9th Cir. 2001).
6. **In re Mondie Forge Co.,** 154 B.R. 232 (Bankr. N.D. Ohio 1993) (Norton Bankr. L. & Prac. 2d §§ 25:9, 27:3, 27:17; Bankr. Serv., L Ed §§ 16:546, 16:576, 16:606, 16:607, 16:970, 16:1014, 16:1017, 16:1059, 29:334, 29:335, 29:337); **United States Trustee v. Garvey, Schubert & Barer (In re Century Cleaning Serv., Inc.),** 195 F.3d 1053, 1060 (9th Cir. 1999) (Norton Bankr. L. & Prac. 2d § 26:5; Bankr. Serv., L Ed §§ 16:21, 16:22, 16:621, 16:622, 16:626, 16:966, 16:1147, 32:45) (abrogated by **Lamie**) ("Policy considerations also counsel in favor of allowing attorneys to receive reimbursement under § 330. There are several post-petition services commonly performed by the debtor's attorney in Chapter 7 proceedings that are necessary to the administration of the estate.").
7. The entire transcript of oral argument in **Lamie** may be found by going to http://www.BankruptcyMedia.com and click on "Lamie oral argument" at top of screen, right.
8. See, e.g., **United States Trustee v. Garvey, Schubert & Barer (In re Century Cleaning Services, Inc.),** 195 F.3d 1053 (9th Cir. 1999) (abrogated by **Lamie**) (lists of tasks performed by the attorney after conversion from Chapter 11 to Chapter 7).
9. **Bethea v. Robert J. Adams & Assocs.**, 352 F.3d 1125 (7th Cir. 2003), cert. denied, 2004 WL 565954 (U.S. 2004); **Hessinger & Assocs. v. United States Trustee (In re Biggar),** 110 F.3d 685 (9th Cir. 1997) (Norton Bankr. L. & Prac. 2d §§ 27:10, 27:18; Bankr. Serv., L Ed §§ 16:482, 16:489, 16:496, 22:17, 22:852, 39:23, 39:564, 39:565, 52:312, 52:315, 52:399); **In re Chandlier**, 292 B.R. 583 (Bankr. W.D. Mich. 2003); **In re Nieves,** 246 B.R. 866 (Bankr. E.D. Wis. 2000) (Bankr. Serv., L Ed §§ 14:136, 39:18, 39:564, 57:10); **In re Haynes,** 216 B.R. 440 (Bankr. D. Colo. 1997) (Norton Bankr. L. & Prac. 2d §§ 26:9, 27:10, 27:18; Bankr. Serv., L Ed §§ 16:731, 16:1034, 16:1066, 16:1078); **Matter of Warman,** 214 B.R. 491 (Bankr. D. Neb. 1997) (Bankr. Serv., L Ed § 25:124); **In re**

Martin, 197 B.R. 120 (Bankr. D. Colo. 1996) (Norton Bankr. L. & Prac. 2d §§ 27:10, 27:18; Bankr. Serv., L Ed §§ 16:482, 16:486, 16:540, 16:575, 16:592, 16:612; 21:171; 27:32, 52:321, 52:322, 52:326).

10. An earlier survey conducted by the National Association of Consumer Bankruptcy Attorneys in 1996 indicated that at that time approximately 13% "always" collected only a partial retainer, and another 16% did so "frequently."
11. Consumer Bankruptcy Letter survey, supra.
12. Typically such money would come from the debtor's postpetition earned income which would not be property of the estate. See 11 U.S.C. § 541(a)(6).
13. **In re Egwim,** 291 B.R. 559 (Bankr. N.D. Ga. 2003); **Oconee State Bank v. Wilson (In re Wilson),** 282 B.R. 278 (Bankr. M.D. Ga. 2002) (Bankr. Serv., L Ed §§ 39:654, 39:658, 58:31, 58:35, 58:58, 58:59, 58:60, 58:61, 58:72, 58:73, 58:78, 58:80, 58:83, 58:86, 58:116, 58:117, 58:118, 58:123, 59:627, 59:628, 59:631, 59:632, 59:637, 59:639, 59:670, 59:641, 59:642, 59:643, 59:645, 59:646, 59:647, 59:648, 59:649, 59:668, 59:693, 59:720); **In re Castorena,** 270 B.R. 504 (Bankr. D. Idaho 2001) (Norton Bankr. L. & Prac. 2d § 27:19; Bankr. Serv., L Ed §§ 16:488, 16:535, 16:548, 16:569, 16:576, 16:635, 16:670, 16:676, 16:677, 16:727, 16:756, 16:761, 16:781, 16:782, 16:783, 16:819); **In re Woodcock,** 100 B.R. 520 (Bankr. E.D. Cal. 1989) (Bankr. Serv., L Ed §§ 16:491, 16:510, 16:548).
14. "When the debtor's attorney fails to appear, the trustee should advise the debtor of the right to proceed without an attorney or to request a continuance to ensure the debtor is represented by an attorney. The trustee should consider filing a motion under § 329(b) to compel turnover or refund of the fees received by an attorney who unjustifiably fails to appear." HANDBOOK FOR CHAPTER 7 TRUSTEES, Ch.7.
15. Possible methods that may be explored include attorney's liens on the funds, reaffirmation of fee agreements, payment from third parties, debtors exempting the funds on deposit, "earned-on-receipt" and advance payment retainers, and similar avenues. Each of these raise questions and issues that should be addressed in another essay.

ELECTRONIC CASE FILING: IT DOESN'T HAVE TO BE ANARCHY

by Keith Lundin
Nashville, TN

Neither the Administrative Office of the United States Courts nor the Judicial Conference of the United States is exercising any substantial control over the implementation of Electronic Case Filing (ECF) in bankruptcy courts across the country. In other contexts this would be good news to those who are skeptical of centralized control within the Judiciary; but in this high-tech aspect of court management, there are problems brewing for the bankruptcy bar. [See NORTON BANKR. L. & PRAC. 2d §§ 151:53-151:58; West's Key Number Digest, Bankruptcy 🔑 2127, 2127.1, 2129, 2131, 2132, 2133.]

The first principle behind this ECF revolution is that the system being delivered to the bankruptcy courts was designed backwards from existing information technology within the Judiciary and the Administrative Office of the United States Courts. After decades of investing in failing systems such as BANCAP and NIBS, those same systems are the platform for the development of ECF and its internal counterpart, Electronic Case Management. This means that "system users"—you out there, debtor and creditor attorneys and the public—didn't come first in the design of ECF. In fact, you were hardly consulted at all. Consequence: there are major aspects of ECF that are not just user unfriendly, some aspects of ECF are genuinely less efficient than existing paper-based procedures.

The second principle is that each local bankruptcy court is free to customize what they get from the information technology folks at the Administrative Office. Consequence: There will be 100 different ECF systems when each court gets done making ECF "right" for that court. Screens won't be the same from one district to the next. The things you can do by ECF won't be the same. The same actions on ECF won't have the same effects from one district to the next.

The third principle of ECF is that the local rule monster will dominate ECF practice in ways you never dreamed of. There will be 100 different general orders or administrative procedures governing ECF and the differences won't be benign for your practice. Consequence: Malpractice premiums will go up.

Most districts are not using formal local rules to manage Electronic Case Filing because the local rules process under Bankruptcy Rule 9029 is too cumbersome. The ECF landscape is shifting so fast that the courts need more flexibility, so most courts are using relatively invisible "general orders" and "administrative procedures" rather than formal local rules.

The variations in local procedures for ECF are unlimited and scary. For example, when you file an ECF document in one district, you may be subject to an administrative order that requires you to archive the paper version of that electronically filed document for as long as seven years. In another district, the retention rule will be three years. In a third district, there will be no special requirement with respect to the paper form of an electronically-filed document. And when you push the button you are certifying that your firm's document retention policy satisfies all of the districts in which you electronically file.

Have you looked at local procedures with respect to the requirements to register as an ECF user? Some places you have to train in "our" training room or, well, get yourself local counsel. Never mind that "our" system is fundamentally just an embellished version of the one in your home district—pass "our" test or don't use ECF here. And then there are "lowest common denominator" courts that will let you get an ECF registration number if you are ECF registered in any other district in the country. (We are going to be the spoiler district that grants an ECF password to anyone who wants one.) Eventually there will be 100 different registration rules.

Fourth principle: Revenue first; service, whenever. The implementation of ECF couldn't come at a worst time for the bankruptcy courts. Filings are at the highest levels ever. Funding for the courts is frozen. New hardware, software, and technically-skilled people are needed in every court and there is no new money. The mandate to implement ECF now is not related to the capacity of the bankruptcy courts to get the job done right. Consequence: your monthly PACER bill will grow exponentially, but don't count on better service from the bankruptcy courts.

The message to the bankruptcy courts from the Administrative Office of the United States Courts is: "Tell the employees in your clerk's office to work harder." Well, those employees have to manage existing paperwork loads, train for and implement a new paperless electronic filing system, and do these things with less money and fewer people. What manager in the private sector would survive this scenario?

It is not too late to start fixing some of these problems. The Advisory Committee on Bankruptcy Rules of the Judicial Conference has talked about ECF and should go ahead and tackle the less controversial aspects, such as: document retention, use and meaning of "electronic signatures," the length of the "ECF day," and the like. Even a little standardization of the ECF rules would go a long way.

The bankruptcy bar and bankruptcy bar associations need to get into the ECF game before it gets further out of control. The bankruptcy bar is fundamentally involved in many ways that it may not have fully realized. "Training" rules to get an ECF registration number seem benign until viewed as one more whack at out-of-district attorneys. Last week you may not have needed "local counsel" to file a motion for relief from the stay by mail; but this week, in a "mandatory" ECF district with a local training requirement, you can't just electronically file that motion because you don't have a registration number. This is the sort of stuff that bar associations should be looking at and voicing opinions about. Is ECF a step toward national bankruptcy practice or a step back from it?

And where is the ECF research? Is anybody out there studying whether ECF makes a difference and in what ways? Is the public better served in an ECF district? What is the impact of ECF on the cost of a debtor law practice? Are fees going up in consumer bankruptcy cases to cover the cost of ECF conversion? Does ECF increase or decrease the cost of administering a Chapter 7 or a Chapter 13 case?

ECF is a great risk and a great opportunity. There won't be a return to paper. There will be a chorus of demands for more and more money to fix the ECF system in the years ahead. The Feds will own the data and access to that data will be paid for seven cents at a time whatever the quality of service to the bar and public. Will the administration of bankruptcy cases be improved? Will bankruptcy practitioners say, hey my life is better because of ECF? Will this technology make service to the public better? These are not the questions the ECF folks started with, but it is not too late to move these questions to the front deck now.

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