"Assisted Person" Status and §526(a)(4)'s Limits on Complete & Competent Legal Representation

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From a declaration of principles jointly adopted by a committee of the American Bar Association and a committee of publishers.

Introduction

This article explores some of the issues that have arisen or will arise as a result of the interplay between the application of: 1) "assisted person" in §101(3) (hereafter "AP"); and 2) the limitations on Debt Relief Agencies (hereafter "DRA") in §526(a)(4). In particular, these sections create new obligations on debtor's counsel to carefully identify, examine, analyze and determine, at the outset of any engagement (or potential engagement), whether or not the client is an "assisted person" or not.

A client's or potential client's designation as an assisted person has significant consequences for the scope of representation and advice that counsel can provide:

- Assisted Person -- the limitations of §526(a)(4) apply
- Nonassisted Person – the limitations of §526(a)(4) do not apply

The main issue in determining who qualifies as an assisted person will be whether the person's debts are "primarily consumer debts." The article concludes with some examples of how the §526(a)(4) limitations will apply in practice.

It is this author's opinion that the answer to those questions will determine the scope of the representation, range of advice, consideration of alternatives and quality of advice that can be provided to any particular client. Under the old law, counsel routinely made

this determination in those cases in which clients with failed business ventures and / or meaningful disposable income desired to file chapter 7 proceedings.

Who Is an Assisted Person under BAPCPA?

The statute defines an assisted person in §101(3) as:

1) a person,[1]

2) who has debts,[2]

3) that are primarily consumer debts,[3]

4) whose nonexempt property is less than $150,000.

Most of the definitional criteria are set forth in the specific sections of §101 as cited. This section of the article will focus on the phrase "primarily consumer debts" which lacks a specific statutory definition in §101, but is contained in both old and new §707(b) and has been the subject of extensive litigation and reported decisions before the enactment of BAPCPA.[4]

Sorting Out Prospective Clients: Triage

Counsel will need to make the AP / non-AP determination at the outset of the of any engagement in which a prospective client is or has been self employed, in business, has debts arising out a failed business venture or otherwise has nonconsumer debt.

Those cases at either extreme end of the spectrum these issues will be fairly easy to characterize:

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[1] *See* §101(41) and note that the term "includes individual, partnership and corporation." However, partnerships or corporations cannot be assisted persons since consumer debt must be incurred by an individual.

[2] The term "debt," defined in §101(12), means "liability on a claim;" "claim" is defined in §101(5).

[3] The term "consumer debt" is defined in §101(8) and is limited to debts "incurred by an individual."

[4] A good discussion of these cases is found in an annotation entitled "What are 'primarily consumer debts,' under 11 USCS §707(b), authorizing dismissal of chapter 7 bankruptcy case if granting relief would be substantial abuse of chapter's provision," 101 ALR Fed. 771

Clearly Primarily Nonconsumer Debt [5]: the client's debts will be clearly nonconsumer debts, the client will not be an assisted person and counsel can provide the full range of advice and alternatives.

Clearly Primarily Consumer Debt [6]: The clients debts are clearly consumer debt, the client has less than $150,000 in nonexempt property and the client is an AP as defined in §101(3). The scope and quality of the representation will be limited by §527(a)(4).

It is prospective clients in the middle of the spectrum who will be the most difficult to characterize as either APs or non-APs.

Clearly Neither: Here is the most troublesome terrain for counsel. This is the client who was self employed and whose debts are a mixture of consumer and non-consumer. In order to properly represent this client, counsel must determine at the outset of the engagement if this client's debts are or are not primarily consumer debts.

What Types of Debts Are "Consumer Debts"?

The statutory definition of a consumer debt is "a debt incurred by an individual for personal, family or household purposes." Cases construing the consumer-debt definition have consistently applied this definition to conclude the following are consumer debts:

- home mortgage debt (both purchase money and home improvement loans)[7]
- all secured debt incurred for personal, family or household purposes[8]
- Consumer debt is further distinguished from nonconsumer debt as a debt incurred with a profit motive."[9]
- Intra family loans used primarily for family living expenses during medical school (Stewart $320,000)
- Student loan debt[10]

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[5] This client could be a sole proprietor whose business activity is reported on schedule C or could be the owner or a closely held corporation, LLC or in some other entity.

[6] This client will fit will fit the typical consumer profile: a W-2 wage earner, home mortgage and car loan debt, credit card debt for consumer goods & services, has not been in business or self employed in the past.

[7] *In re Price*, 353 F. 3d 1135, 1139 (CA 9 2004).

[8] *In re Kelly*, 841 F.2d 908, 913 (CA 9 1988).

[9] *In re Stewart*, 175 F.3d 796, 806 (CA 10 1999), affirming 215 B.R. 456 (BAP) and 201 B.R. 996 (N.D. Okla.).

- Alimony (Stewart $250,000)

When Are a Client's Debts Primarily Consumer Debts?

- "a debtor is considered to have 'primarily consumer debts' under §707(b) when consumer number of consumer debts constitute more than half of the total number of debts."[11]

- "we therefore define 'primarily' in the context of §707(b) as meaning consumer debt exceeding fifty percent of the total debt."[12]

- Both: 1) fifty percent or more of the total amount of debt; and 2) actual number of consumer debts must exceed at least one half of the total number of debts.[13]

The Limitation on Competent Representation of an Assisted Person

BAPCPA created a new form of law firm in §101(12A) and called it a DRA. It also added a convoluted, redundant and burdensome series of restrictions (§526), disclosures (§527) and requirements (§528) on DRAs.

One of those restrictions, contained in §526(a)(4) of the Code, is particularly troubling and is the focus of this article:

§526. Restrictions on debt relief agencies

(a) A debt relief agency shall not—

> *(4) advise an* **assisted person** *or* **prospective assisted person** *to incur more debt in contemplation of such person filing a case under this title or to pay an attorney*

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[10] *In re Stewart*, 175 F.3d 796, 807 (CA 10 1999). Dr. Stewart had $218,000 in student loan debt. The 10th Circuit left the door open on this issue: whether student loan debt is "consumer debt," stating it was "unwilling to characterize the entire $218,000 as consumer debt" due "to the lack of evidence in the record and authority to guide us." The opinion suggests that portion of student loan debt that went to "the actual cost of . . . tuition, books or other direct educational expenses" might be non consumer debt in contrast "to the portion of student loans used for personal, family and household expenses." This highlights the importance of fully developing the factual record at trial which is often a problem for counsel in consumer cases.

[11] *In re Price*, 353 F. 3d 1135, 1139 (CA 9 2004).

[12] *In re Stewart*, 175 F.3d 796, 808 (CA 10 1999).

[13] Matter of Booth, 858 F.2d 1051 (CA 5 1988).

or bankruptcy petition preparer fee or charge for services performed as part of preparing for or representing a debtor in a case under this title.

The legislative history on this entire section is scant and of little use in determining what was intended by this specific section.[14]

Examples of practical applications of the §526(a)(4) limits on routine competent legal assistance

The following scenarios consider the limits that §526(a)(4) places on what is normally considered routine pre filing legal advice by consumer debtor counsel:

Example #1: Routine workout /debt restructuring advice:

FACTS: An assisted person has significant equity in a homestead and credit card debt roughly equal to the equity in the homestead.[15] During the initial consultation, the client's articulated goal is to avoid bankruptcy, if possible, and to pay the credit card creditors. At the initial consultation, counsel considers (privately, to himself) various options, including using the equity in the homestead via a second mortgage or a refinance as a means of funding a compromise settlement proposal of the existing debt. Counsel outlines the chapter 7 and 13 options to the client and contemplates how to meet the client's goal of avoiding bankruptcy.

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[14] That legislative history is contained in the Section by Section Analysis & Discussion, House Report 109-31, Report of the Committee of the Judiciary, House of Representatives, to Accompany S. 256, page 66:

> *Sec. 227. Restrictions on Debt Relief Agencies.* Section 227 of the Act creates a new provision in the Bankruptcy Code intended to proscribe certain activities of a debt relief agency. It prohibits such agency from: (1) failing to perform any service that it informed an assisted person it would provide; (2) advising an assisted person to make an untrue and misleading statement (or that upon the exercise of reasonable care, should have been known to be untrue or misleading) in a document filed in a bankruptcy case; (3) misrepresenting the services it provides and the benefits and risks of bankruptcy; and (4) advising an assisted person or prospective assisted person to incur additional debt in contemplation of filing for bankruptcy relief or for the purpose of paying fees for services rendered by an attorney or petition preparer in connection with the bankruptcy case. Any waiver by an assisted person of the protections under this provision are unenforceable, except against a debt relief agency.

[15] The prohibition against incurring secured debt is not limited to homesteads but is applicable to a host of other assets as well. For instance, the restriction of §526(a)(4) would prohibit advice by counsel to borrow against assets such as pension plans (SEP's, 401(k)'s, IRA's etc.) and cash value life insurance.

These types of assets are either excluded from the estate or are typically totally or partially exempt under applicable exemption statutes. Borrowing from these types of assets to fund workout plans would not result in any diminution of the estate or shrink the pool of assets available to creditors. What business does BAPCPA have prohibiting borrowing against assets that are not even estate property and which creditors or a trustee could not reach in any event?

COMMENT: The problem here is that, at the outset, a bankruptcy proceeding is under consideration and contemplated by both the client and the lawyer. Under §526(a)(4), counsel is prohibited from advising the client to incur more debt (the second mortgage on the homestead) to fund the proposal. Under §526(a)(4), even if the debtor and counsel had written commitments from the creditors to accept specific dollar amounts on their claims, counsel is still precluded from advising the client to incur debt to fund the workout.

The net effect of the restriction is that consideration of or advice to a client to borrow from even exempt assets in order to fund a workout is prohibited. Under §526(a)(4) counsel is prohibited from advising an AP to create secured debt (with a greater likelihood of being repaid) and swapping it for unsecured debt.

Example #2: limits on prebankruptcy planning:

FACTS: An assisted person has $120,000 in equity in the homestead in a state with a $100,000 limit. Can counsel advise this AP/debtor to get a second mortgage for $20,000, use it to pay off nondischargeable student loan or tax debt and pay $2,000 on counsel fees for the upcoming chapter 7? After this transaction, the equity in homestead will be totally exempt and nonexempt equity in the asset has been applied to nondischargeable student loans or taxes.

COMMENT: The problem here is the same as example #1 above. At the outset a bankruptcy proceeding is under consideration and contemplated by both the client and the lawyer. Under §526(a)(4), counsel is prohibited from advising the client to incur more debt (the second mortgage on the homestead) to pay off legitimate nondischargeable debt.

Example #3: interference with totally unrelated financial plans:

FACTS: The AP/debtor is in the midst of refinancing for reasons totally unrelated to a bankruptcy case but consults with counsel about filing bankruptcy.[16] Counsel does not even know about AP's plans to refinance until the eve of filing, when debtor reminds counsel that a new secured creditor needs to go onto schedule D. Does that mean this AP/debtor now borrowing in contemplation of filing a case ?

COMMENT: The AP may be borrowing in contemplation of filing the case, but counsel was not aware of these plans and has not advised the AP to incur debt. The restriction of §526(a)(4) extends to advice by counsel. Counsel would be well advised to document his lack of knowledge of the AP's refinance plan.

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[16] Let's change the facts just slightly. Debtor is finishing up a divorce, staggering under the burden of excessive credit card debt and now must get a second mortgage on blackacre to payoff the property settlement with the soon to be ex-spouse. Debtor talks to divorce counsel about this sorry state of affairs and divorce counsel suggests debtor consider filing bankruptcy. Is divorce counsel now a DRA? Does the fact that this advice came from divorce counsel somehow cleanse it?

Example #4: a real life workout fact pattern:[17]

FACTS: At an initial consultation with an AP/prospective debtor/client counsel learns that:

- the AP is self employed veterinarian in northwest Montana
- although she has some nonconsumer business debt, her debts are primarily consumer debt (for most consumers, including this client, the existence of one or two home mortgages tips the scale to primarily consumer debt)
- she has a home mortgage of more than $100,000 and about $20,000 in credit card debt
- to start her business, she incurred secured debt with a national lender (Vet Debt) to finance acquisition of veterinary equipment. The loan balance is about $45,000 and the equipment is now worth perhaps $25,000. A UCC lien search confirms the creditor has properly perfected the security interest. She is in default on this obligation and the creditor is calling regularly and demanding voluntary surrender
- The AP/debtor's goals are to: a) avoid bankruptcy, b) continue the business and c) retain the equipment. The AP/debtor claims that if she can get Vet Debt to back off she can handle the rest of her situation.

At the initial consultation, counsel advises here that her options include chapter 7, 13 or attempting a workout with Vet Debt followed by a reevaluation of the bankruptcy options. Bankruptcy is contemplated as a decisive remedy for the problems if the workout is not successful.

Before beginning workout discussions with Vet Debt, counsel confirms the debtor has the resources to fund a compromise settlement. Debtor discloses she could borrow against the equity in her residence and has another credit line with about $25,000 available on it.

Discussions with Vet Debt are successfully concluded for a lump-sum payment of $25,000 in exchange for release of it's security interest. Debtor borrows the funds from the credit line and incurs $25,000 of new unsecured debt to get rid of $45,000 of old secured debt.[18]

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[17] The author negotiated this workout on behalf of the debtor / client in the spring of 2005, just about the time the president signed BAPCPA into law.

[18] After sharing this example with some of my professional colleagues they have pointed out that one interpretation of §526(a)(4) is that the phrase "*incur more debt*" refers to more net debt rather than any

COMMENT: Counsel can no longer provide these services to this AP. Although in business, her debts are still primarily consumer debts and §526(a)(4) prohibits this type of advice. Applied to this case, the end result is that this type of a compromise will not happen under BAPCPA, Vet Debt would have to retain counsel and file a replevin or claim & delivery action and wind up with less net economic recovery than the workout produced.

Conclusion

As noted at the outset, the intersection between designation as an AP and the limitations contained in §526(a)(4) have profound consequences on the scope of the representation, range of advice, consideration of alternatives and quality of advice that can be provided to any particular client. In light of the consequences arising from the restrictions of §526(a)(4), counsel must determine at the outset, or fairly early in the engagement, if the client is an AP or not, which will turn on wither the debts are primarily consumer debts.

In some cases this will be self evident or fairly easy from an initial examination of the client's debts. In other cases, this determination will require a fact intensive, detailed examination and analysis of the debts, application of the existing law and a written opinion to the client.

If the client is an AP, the scope and quality of counsel's advice will be limited and / or undermined by §526(a)(4). The practical examples are intended to alert readers to real life limitations imposed by that section.

NOTE: Earlier this summer, at least one court has invalidated §526(a)(4), The ABI BAPCPA blog recently reported:

> **ABI BAPCPA BLOG UPDATE: PORTION OF BAPCPA "DEBT RELIEF AGENCY" PROVISIONS HELD UNCONSTITUTIONAL**
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> Almost immediately after BAPCPA was passed, questions arose over the application of certain provisions governing the conduct of "debt relief agencies" to attorneys. In *Hersch v. United States*, Case No. 3:05-CV-2330-N (N.D. Tex. 7/26/06), a court has now squarely addressed the constitutionality of portions of these BAPCPA provisions, and found that they violate the First Amendment. Attorney **Susan Hersh** (misspelled in the case cite), a Texas attorney whose practice includes counseling clients regarding potential bankruptcies, filed an action in district court seeking a declaratory judgment that BAPCPA does not apply to attorneys, and that several of its provisions are unconstitutional. Specifically, the provisions at issue were 11 U.S.C. 526(a)(4), which prohibits "debt-relief agencies" from giving certain advice, and 527, which requires "debt-relief agencies" to make certain disclosures. The government initially contested Hersh's standing on the basis that nobody had taken any action against her to

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debt. In other words, applied to this fact pattern, counsel can advise the client to incur the $25,000 of new debt to satisfy the old $45,000 secured debt, because the net result is not more debt, but less net debt. Who wants to be the guinea pig to test this theory in their home court or state ethics panel?

enforce the BAPCPA provisions against her. The court rejected this argument, finding that the alleged suppression of her speech under BAPCPA was sufficient to give standing.

However, this decision and others may be under appeal, they apply or control only within the jurisdictions in which they were rendered and, to the author's knowledge, there is no circuit-level authority on this topic. Accordingly, unless your jurisdiction is one that has invalidated §526(a)(4), it remains a valid statute which counsel must comply with.