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# retaining the professional retainer when the client is in financial distress

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*MSK Client Alert*

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## **practice areas**

corporate & business transactions

How can a professional ensure payment for services appropriately and professionally performed, even in the face of the client's bankruptcy filing? Professionals considering representing a client in potential financial distress, in particular, will be interested in this discussion of the professional retainer, who owns it and when, and how to hold onto it.

### **Retainers Are Property of the Client**

A retainer, typically, is a fee advance. It is intended to secure the client's payment of fees for future services. The professional earns the fees by performing professional services for the client, bills the client on a monthly basis, and then draws down the retainer to pay himself or herself the earned fees. The typical engagement letter provides for this, although it often has misleading language that calls the retainer property of the professional.

One variant is the "evergreen retainer," which comes in two forms. In the first form, the client is to pay regularly and the professional will not tap the retainer for payment until the final bill is due or, in bankruptcy representation, until the final fee application is approved by the court. In the second form, the professional regularly draws down from the retainer and regularly requires that the client replenish it.

These retainers are property of the client until drawn down--regardless of what the engagement letter says. Contracts between lawyers and clients are subject to ethics rules, the prototypes of which are set forth in the Model Rules of Professional Conduct. California's Rule of Professional Conduct 4-100 entitled "Preserving Identity of Funds and Property of a Client" requires that clients' funds, including advances for costs and expenses, must be deposited in client trust accounts. It is likely that professionals in other fields have similar rules with regard to advances.



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### Property of the Client Is Part of the Client's Bankruptcy Estate

If a client files for bankruptcy relief or becomes the subject of an involuntary petition filed by its creditors, generally all property of the client becomes "property of the estate" under the Bankruptcy Code. The significance of this is twofold:

First, the automatic stay that comes into effect upon the filing of a bankruptcy petition precludes the professional from, among other things, acts to obtain property of the estate and recover prepetition claims. The professional can no longer draw down against the retainer, even if the fees have been earned and both the contract with the client and the ethics rules would otherwise permit a draw-down. In order to pay itself from the retainer, the professional will have to move the bankruptcy court for "relief from the automatic stay" and prove its priority entitlement to the funds held as a retainer. Although such a motion is relatively routine, the professional will have to either engage bankruptcy counsel and pay such counsel or, if the professional is himself or herself a bankruptcy lawyer, forgo other opportunities to take the time to do this unpaid legal work.

Second, until the professional has earned, billed, and drawn down from the retainer for the fees, the money held as a retainer in the client trust account may be subject to a claim from a third party that takes precedence. What is the professional's interest in the retainer sitting in the client trust account? Since the retainer continues to be property of the client, the professional's interest in the retainer must be a security interest. Three issues are paramount:

1. Does the professional have a valid security interest in the retainer?

The best way to ensure, and prove, that the client intended to grant the professional a security interest in the retainer (as it is then and as it may subsequently be replenished) is for the client to agree to this in the engagement letter that the client signs. Many retainer agreements simply say that the retainer is the property of the professional, and when it turns out that is not the case, those retainer agreements frequently do not have language creating a security interest in the retainer. Often a court will infer such a security interest as that is the obvious purpose of the retainer, but it is better practice to make this explicit.

1. Is the security interest in the retainer properly perfected?

Bankruptcy law often permits a trustee, or a debtor-in-possession where there is no trustee, to undo a security interest that is not properly perfected. However, under the Uniform Commercial Code, a security interest in money is automatically perfected by possession without the need for the filing of a financing statement. Why not have the retainer agreement say that the security interest is automatically perfected, but the client nonetheless agrees to execute and file any documents the professional reasonably requests to perfect or continue the perfection? This is a belt-and-suspenders approach, but if the funds transferred to the professional as a retainer are of uncertain origin, and the professional nevertheless decides to take on the matter after doing a UCC search and undertaking appropriate due diligence, it may behoove the professional to file his or her own UCC-1 to give notice to the world of the security interest. There are still risks, such as the precedence of criminal forfeiture, but at least some investigation will facilitate making an informed decision.



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### **The Best Strategy**

Ownership of the retainer is key. Once a professional has properly paid himself or herself from the retainer, it is property of the professional, not property of the client or the client's bankruptcy estate. There are still circumstances under which a bankruptcy trustee can claw back that money, most of which arise from criminal behavior by the client, but having been paid puts the professional in a far stronger position, and the bankruptcy trustee will have to take action if he or she contends that the funds the professional has been paid belong to the estate.

When fees have been earned, bill them and draw down from the retainer. Although monthly billing is typical, any professional who knows or suspects that his or her client is in distressed financial condition should bill the client biweekly or weekly and draw down the billed amount. Ideally, this will be combined with a request that the client replenish the retainer. In the engagement letter, or a supplement to it, have the client agree to accelerated billing at the professional's discretion and agree to the form of evergreen retainer that requires the client to replenish the retainer as soon as it has been drawn down and a request for replenishment has been made. As the adage says, "In possession is nine-tenths of the law."

If you have any questions about the Alert, please contact Bankruptcy Counsel Mary Lane.