MALPRACTICE CONSIDERATIONS IN BANKRUPTCY

LOU JONES BREAKFAST
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I. DEFINING MALPRACTICE.

A. In Wisconsin, the standard for lawyer malpractice has long been established:

> "[A]n attorney must be held to undertake to use a reasonable degree of care and skill, and to possess to a reasonable extent the knowledge requisite to a proper performance of the duties of his profession . . . ."

Gustavson v. O'Brien, 87 Wis. 2d 193, 199 (1979), *quoting Malone v. Gerth*, 100 Wis. 166, 173 (1898).

B. The applicable duty of care has been defined as follows:

> "[A]n attorney is bound to exercise his best judgment in light of his education and experience, but is not held to a standard of perfection or infallibility of judgment."

Helmbrecht v. St. Paul Ins. Co., 122 Wis. 2d 94, 111 (1985). *See also Bularz v. Hinkfuss,* 2004 WL 201070 (Wis. Ct. App. 2004).

C. Wisconsin Civil Jury Instruction 1023.5 also provides some guidance:

> In providing legal services to a client, it is a lawyer's duty to use the degree of care, skill, and judgment which reasonably prudent lawyers practicing in this state would exercise under like or similar circumstances. A failure to conform to this standard is negligence. The burden is on (plaintiff) to prove that (lawyer) was negligent.
>
> You are to determine whether (lawyer) was negligent in representing (plaintiff) in light of the facts and circumstances of which (lawyer) was aware or should have discovered at the time the legal services were provided to (plaintiff). A lawyer is negligent if the lawyer fails to discover or recognize the importance of relevant facts or legal principles which reasonably prudent lawyers would discover or recognize or if the lawyer's skill or judgment was not consistent with that exercised by reasonably prudent lawyers. A lawyer is not negligent because of the results of (his)(her) representation, if [the lawyer's] efforts were those reasonably prudent lawyers would have taken.

D. The elements that a plaintiff must show in order to prevail in an attorney malpractice case are:

1. The existence of an attorney-client relationship;
2. The acts constituting the alleged negligence;
3. The negligence was a proximate cause of the injury; and,
4. The fact and extent of the injury alleged (damages).

Lewandowski v. Continental Casualty Co., 88 Wis. 2d 271, 277 (1979).

E. The last two elements often require a "trial within a trial" -- *i.e.*, the client has the burden of showing that but for the lawyer's negligence, the client would have been successful in the prosecution or defense of an action. *See Lewandowski*, 88 Wis. 2d at 277.

F. Expert testimony is normally required because the degree of care, skill, and judgment that reasonably prudent lawyers exercise is not a matter within the common knowledge of lay people. *Pierce v. Colwell*, 209 Wis. 2d 355, 362 (Ct. App. 1997). *See also Bularz v. Hinkfuss*, 2004 WL 201070, discussed at page 12 (malpractice claim based on bankruptcy law requires plaintiff to produce expert testimony).

1. However, expert testimony is not necessary "when the [lawyer's] breach is either so obvious that it may be determined by the court as a matter of law, or when it is within the ordinary knowledge and experience of laypersons." *Thiery v. Bye*, 228 Wis. 2d 231, 245 (Ct. App. 1999), citing *Helmbrecht v. St. Paul Ins. Co.,* 122 Wis. 2d 94, 112 (1985).

2. In *Olfe v. Gordon*, 93 Wis. 2d 173 (1980), the client alleged negligence by the lawyer in failing to follow her specific instructions. The court concluded that proof of this type of negligence does not require expert testimony.

G. A higher standard of care applies to lawyers who represent themselves as being specialists in a particular area of law. *Duffey Law Office, S.C. v. Tank Transport, Inc.*, 194 Wis. 2d 674, 686 (Ct. App. 1995).

1. Where a lawyer has held himself or herself out as a specialist in the relevant area of law, the following additional paragraph should be used in the jury instructions:

> "Lawyers who present themselves to the public or their clients as having special experience, knowledge, or skill in a particular area of law are held to the standard of care of reasonably prudent lawyers with that special experience, knowledge, or skill. This is the standard you should apply in considering question __ of the special verdict."
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> Wisconsin Civil Jury Instruction 1023.5.

2. Most areas of practice do not have State Bar sanctioned specialty certification. *See* Wis. SCR 20:7.4 ("A lawyer shall not state or imply that a

lawyer is certified as a specialist in a particular field of law" except in the areas of patent and admiralty). The cases generally present a question of fact concerning whether the lawyer held herself out as a specialist to the public or to the particular client.

3. Qualified lawyers can obtain certifications such as "Business Bankruptcy Specialist" or "Consumer Bankruptcy Specialist" from various private organizations. Doing so likely subjects those lawyers to a higher standard for malpractice rather than the standard applied to a generalist.

H. Contributory negligence by the client can be a defense to liability. *Gustavson v. O'Brien*, 87 Wis. 2d 193, 204 (1979).

I. So can "unclean hands" or the doctrine of "*in pari delicto*." *Evans v. Cameron*, 121 Wis. 2d 421, 431-32 (1985).

J. It is "well established" that the six-year statute of limitations under Wis. Stat. § 893.53 applies to legal malpractice actions in Wisconsin. *Hicks v. Nunnery*, 253 Wis. 2d 721, 737 (Ct. App. 2002).

K. SCR 20:1.8(h) prohibits a lawyer from negotiating away malpractice claims unless the client or former client is independently represented (for prospective waivers) or is advised in writing to seek independent counsel (for existing/potential claims).

II. STATISTICAL OVERVIEW.

A. The American Bar Association periodically analyzes and publishes data regarding legal malpractice claims. According to the 2011 study, bankruptcy and collection matters account for 9.2% of all malpractice claims, up from 7.27% in 2007.

B. Comparing bankruptcy and collection law to other areas of the law:

Area of Practice	Claims in 2011	Percent	
Real Estate	10,772	20.05%	
Personal Injury – Plaintiff	8,260	15.59%	
Family Law	6,432	12.14%	
Estate, Trust and Probate	5,652	10.67%	
Collection and Bankruptcy	4,876	9.20%	◄◄
Corporate/Business Organization	3,597	6.79%	
Criminal	2,996	5.65%	
Business Transactions/Commercial Law	2,176	4.11%	
Personal Injury – Defense	1,727	3.26%	
Labor Law	1,160	2.19%	
Workers Compensation	1,007	1.90%	

C. WILMIC, a mutual insurance company formed by Wisconsin law firms, shared the following report with respect to the claims it paid out during 2014:

Area of Practice	Percent of 2014 Claims Made	Percent of Payout on All Claims
Plaintiff Personal Injury	19.90%	28.04%
Real Estate	17.47%	16.73%
Bankruptcy & Collections	10.89%	7.22% ◄◄
Estate, Trust, Probate	10.32%	11.38%
Family Law	9.78%	5.19%
Corporate and Business Organization	3.60%	6.83%
Business Transactions/Commercial Law	3.50%	7.57%
Labor Law	1.64%	1.67%
Patents, Trademark, Copyrights	1.27%	1.81%
Local Government	0.87%	1.67%

D. Last year's figures are consistent with WILMIC's historical data. Since 1986, the top five practice areas for malpractice claims have been:

Plaintiff Personal Injury: 20%

Real Estate: 18%

Bankruptcy & Collections: 11%

Estate, Trust, Probate: 10%

Family Law: 10%

III. WAYS TO CLASSIFY MALPRACTICE CLAIMS IN BANKRUPTCY.

A. By the type of client.

1. Debtors and debtors-in-possession.
2. Secured creditors.
3. Unsecured creditors, individually or as a committee.
4. Owners/equity holders.

B. By the type of case.

1. Consumers under Chapter 7 or 13.
2. Individuals under Chapter 11.
3. Business reorganizations under Chapter 11.
4. Family farmers under Chapters 11 or 12.

C. By the type of attorney error. On the next page are more statistics taken from the ABA and WILMIC. The numbers in brackets represent WILMIC's designation of "type of error" for bankruptcy claims.

1. Substantive Errors – 45.07% of the total ABA claims.

(a)	Failure to know/properly apply law	13.57%	[39%]
(b)	Inadequate discovery/investigation	7.82%	[11%]
(c)	Planning error/procedure choice	7.39%	[17%]
(d)	Failure to know/ascertain deadline	6.91%	
(e)	Conflict of interest	4.28%	
(f)	Error in public record search	3.03%	
(g)	Failure to anticipate tax consequences	1.37%	
(h)	Math error	0.69%	

2. Administrative Errors – 30.13% of the total ABA claims.

(a)	Procrast. in performance/follow up	9.68%	[11%]
(b)	Lost file/document/evidence	7.05%	
(c)	Failure to calendar	4.34%	
(d)	Clerical error	3.54%	
(e)	Failure to file document	3.17%	
(f)	Failure to react to calendar	2.34%	

3. Client Relation Errors – 14.61% of the total ABA claims.

(a)	Failure to obtain consent for action	7.02%	
(b)	Failure to follow client's instructions	5.71%	[5%]
(c)	Improper withdrawal	1.87%	

4. Intentional Wrongs – 10.19% of the total ABA claims.

(a)	Fraud	4.53%	[5%]
(b)	Malicious prosecution	3.43%	[11%]
(c)	Violation of civil rights	1.27%	
(d)	Libel/slander	0.96%	

IV. MISSED DEADLINES.

A. Bankruptcy practice and procedure probably involve more deadlines than any other area of the law.

B. The deadlines can be explicit or implicit:

1. Set forth in the Notice of Commencement of Case mailed by the clerk's office to creditors, using names and addresses provided by the debtor.

(a) Is notice sufficient if directed to a creditor's prepetition collection attorney?

i. Yes. *Altman v. Miller*, 74 N.Y.S.2d 857, 858 (1947) (holding that "notice to the attorney authorized to collect judgment and actually engaged in the collection thereof, was notice to the [creditor]").

ii. No. *In re Fauchier*, 71 B.R. 212, 215 (9th Cir. B.A.P. 1987) ("An attorney who has represented a creditor in state court proceedings does not, by virtue of that relationship alone, represent the creditor with respect to that same debt in a federal bankruptcy proceeding.")

iii. Good analysis can be found in *In re Sedlacek*, 325 B.R. 202 (Bankr. S.D. Tenn. 2005). *See also In re Glow*, 111 B.R. 209, 218 (Bankr. N.D. Ind. 1990).

(b) Notice sent to a lawyer on behalf of one client may not be effective as to another client. *Maldonado v. Ramirez*, 757 F.2d 48, 51 (3rd Cir. 1985) ("[A]n attorney given notice of the bankruptcy on behalf of a particular client is not called upon to review all of his or her files to ascertain whether any other client may also have a claim against the [debtor]").

2. Deadlines found in the Rules. These deadlines can be measured from the petition date, from the order for relief, from the first date set for the meeting of creditors, from the conclusion of the meeting of creditors, or from the date of conversion.

3. Deadlines established by a court order. For example, an order approving a Chapter 11 disclosure statement may set a dozen separate deadlines – for voting, sending notice of the confirmation hearing, objecting to the plan, rejecting contracts, filing a ballot report, filing fee applications, etc..

C. Examples of bankruptcy deadlines and some malpractice cases based on them.

1. Proofs of claim.

(a) By a creditor.

i. Bankruptcy Rule 3002 (Chapters 7, 12, 13) -- within 90 days after first date set for the section 341 meeting (some exceptions).

ii. Bankruptcy Rule 3003 (Chapters 9, 11) -- time fixed by the court.

(b) By the debtor.

i. Bankruptcy Rule 3004 -- 30 days after time for a creditor to file its own claim expires.

ii. *Hutchinson v. Smith*, 417 So. 2d 926 (Miss. 1982). The debtors sued their Chapter 7 attorney on various grounds, including failure to schedule priority tax claims, failure to review proofs of claim filed to make sure taxing authorities had filed claims, and failure to file correct claims on behalf

of taxing authorities. As a result, $900 in local taxes and $737 in IRS penalties and interest were not discharged. The clients sought $34,000 in damages for emotional distress. No decision on the merits, but court decided that the longer tort statute of limitations applies to the malpractice action.

(c) The "excusable neglect" standard for late-filed claims was softened somewhat in *Pioneer Investment Services Co. v. Brunswick Assoc. L.P.*, 507 U.S. 380, 113 S.Ct. 1489, 123 L.Ed. 2d 74 (1993), giving hope to attorneys who have missed a filing deadline. The Court concluded that "excusable neglect" could include inadvertence, mistake or carelessness. However, lower courts have remained stingy about extending the claims deadline. The list of subsequent decisions identified by Westlaw's Keycite service as "distinguish[ing]" or "declin[ing] to extend" *Pioneer Investment* is unusually long even for a precedent that is 20 years old.

2. Discharge and/or dischargeability actions.

(a) Bankruptcy Rules 4004 (discharge) and 4007 (dischargeability) govern the deadline to file the complaint. Again, different deadlines depending on the type of case.

(b) If the creditor's lawyer has actual notice of the bankruptcy case in time to meet the deadline, complaint must be timely filed even if no formal notice of the deadline was received. *In re Alton*, 837 F.2d 457 (11th Cir. 1988). *See also In re Saltzmann*, 25 B.R. 125 (Bankr. E.D. Wis. 1982) (unscheduled creditor must timely file dischargeability complaint if its attorneys had actual knowledge of the case).

(c) Failure to plead in the answer that a late-filed complaint is time-barred could be grounds for a malpractice claim against debtor's counsel. *See Kontrick v. Ryan*, 540 U.S. 443, 124 S.Ct. 906 (2004) (by failing to raise the time limitation before the court reached the merits of the creditor's objection to discharge, debtor forfeited the right to rely on Rule 4004). This case affirms the Seventh Circuit's decision in *In re Kontrick*, 295 F.3d 724 (7th Cir. 2002).

3. Objection to claimed exemptions.

(a) Bankruptcy Rule 4003 requires that objections to the exemptions claimed by a debtor must be filed within 30 days after the conclusion of the section 341 meeting.

(b) The deadline applies strictly, even if there was no colorable claim for the exemption asserted by the debtor. *Taylor v. Freeland & Kronz*, 503 U.S. 638, 112 S.Ct. 1644 1992).

4. Debtor's intention with respect to collateral.

   (a) An individual debtor in a Chapter 7 case whose schedules reflect debts secured by property of the estate must file a statement of intention with respect to such property within 30 days of the petition date, or by the § 341 meeting, whichever is earlier. Code § 521(a)(2)(A).

   (b) The debtor must perform his or her intention with respect to the property within 30 days of filing the statement of intention. Code § 521(2)(B).

5. Assumption or rejection of executory contracts and unexpired leases.

   (a) Under 365(d), depending on the chapter, executory contracts or unexpired leases of residential real property, nonresidential real property or personal property may be rejected automatically if not assumed within 60 days after the order for relief.

   (b) Although not found guilty of malpractice, the attorneys in *In re Melridge, Inc.*, 108 B.R. 748 (D. Ore. 1989) were disqualified from representing the post-confirmation debtor due to the potential malpractice claim arising from their failure to file, within 60 days after the debtor's Chapter 11 petition, a motion to assume a valuable lease.

6. Reaffirmation agreements.

   (a) Reaffirmation agreements must be entered into before the debtor's discharge is granted. Code § 524(c)(1).

   (b) Pursuant to Bankruptcy Rule 4008, a reaffirmation agreement must be filed no later than 60 days after the first date set for the § 341 meeting. The court may "at any time and in its discretion, enlarge the time to file a reaffirmation agreement."

   (c) To be enforceable, a reaffirmation agreement must comply with the disclosure requirements of Code § 524(k). At nearly 2,600 words, this may be the longest subsection in the entire Bankruptcy Code.

   (d) *Klein v. Duren Law Offices*, 2014 WL 1242341 (Wis. Ct. App. 2014) (unpublished opinion) shows what can happen when debtors reaffirm a second (underwater) mortgage and wish they hadn't.

      i. Intending to "use the bankruptcy to help them keep their house," the Kleins filed a chapter 7 petition in late 2009. They planned to negotiate "a modification of a first mortgage" on that home.

      ii. Allegedly without fully understanding the impact, they signed a reaffirmation with Associated Bank on its second mortgage.

iii. Discharge was granted and the case was closed in early 2010.

iv. The Kleins were unable to obtain a modification of their first mortgage. By September 2010, the senior lender filed a foreclosure action.

v. Associated then sued the Kleins for the deficiency on the second mortgage. Represented by different counsel, the Kleins negotiated a settlement with Associated.

vi. They then sued their bankruptcy lawyer for malpractice on the grounds that "entering into the reaffirmation agreement ran contrary to the Kleins' interests."

vii. The bankruptcy lawyer defended on the grounds that the reaffirmation agreement was unenforceable because the Kleins had failed to fill in the blanks on Part D before they signed it.

viii. The trial court concluded that the reaffirmation agreement was indeed unenforceable as a matter of (bankruptcy) law; thus, the Kleins were not able to prove causation. The court of appeals affirmed.

ix. How many possible legal errors can you count?

(e) What steps can lawyers take to insulate themselves from liability in connection with reaffirmation agreements?

7. Responding to a creditor's motion for relief from the automatic stay.

(a) In *Nelson v. Taoka*, 611 N.E.2d 462 (Ohio App. 1992), farm debtors sued their Chapter 11 counsel for failing to respond timely to a secured creditor's motion for relief from the stay. Relief was granted, and the case apparently converted.

i. The state court found that breach of duty and damages were clear, but no causation. "[I]n order to prove that [the lawyer's] alleged malpractice proximately caused their damage, [debtors] were required to show that, but for [the lawyer's] failure to object to [the lift-stay] motion, they could have successfully reorganized." *Id.* at 466.

ii. Debtors' expert witness, a retired bankruptcy judge, could not testify unequivocally that the debtors would have been able to confirm a plan.

8. Furnishing adequate assurance of post-petition payment to utility service. Section 366 allows utilities to alter, refuse or discontinue service if such assurance (usually in the form of a deposit) is not made within 20 days after the order for relief (30 days in Chapter 11).

9. Commencing preference, fraudulent transfer or other avoidance actions: Section 546 establishes a two-year statute of limitations, measured form the entry of the order for relief, except that a trustee first appointed within such two-year period shall have no less than one year to file avoidance actions.

10. Objecting to a disclosure statement or confirmation of a proposed plan. Rule 2002(b) requires 28 days' notice of the deadline for objecting to, and the hearing to consider approval of, a disclosure statement, and requires the same notice for a Chapter 11 or 13 plan.

11. Filing a plan on behalf of the debtor (exclusive periods).

    (a) Section 1121 gives a debtor in possession the exclusive right to propose a plan during the first 120 days of the case and prohibits other parties from proposing a plan unless the debtor has not filed a plan that has been accepted within the first 180 days of the case by any classes impaired under the plan. Both of these time limitations are subject to increase or reduction on motion brought by a party in interest. Code § 1121(d).

    (b) In *Shannon v. Hearity*, 487 N.W.2d 690 (Iowa App. 1992), farm debtors sued their Chapter 11 counsel on the theory that his failure to file a plan within the exclusive period caused their case to convert to Chapter 7.

        i. The trial court entered a directed verdict in favor of the lawyer, finding insufficient evidence that the debtors were damaged.

        ii. The appellate court affirmed the decision because the record failed to show what the debtors lost or what the result would have been in a Chapter 11 case. The court found that the testimony of the debtor's expert witness was inconclusive and not credible.

12. Filing the bankruptcy case itself.

    (a) Timing may be important to preserve the estate's ability to avoid and recover preferences or fraudulent transfers.

    (b) A premature filing may freeze certain taxes as nondischargeable claims, while waiting a bit longer could satisfy the "old and cold" rules of section 507(a)(8). *See, e.g., In re Saunders*, 2003 Bankr. LEXIS 1819 (Bankr. S.D. Fla. 2003) (unpublished opinion).

    (c) *Justice v. Carter*, 972 F.2d 951 (8th Cir. 1992).

        i. The plaintiffs (farm debtors) sued their attorney for failing to advise them of the adverse consequences from waiting to file a Chapter 12 bankruptcy until after a sheriff's sale. The jury returned a verdict in favor of the attorney.

ii. On appeal, the debtors challenged a jury instruction concerning the absolute priority rule. They asserted that the instruction should have been based on the Eight Circuit's decision in *In re Ahlers*, 794 F.2d 388 (8th Cir. 1986) (sweat equity can satisfy new value exception to absolute priority rule), which was a binding precedent at the time of their own bankruptcy, rather than the later reversal of that decision by the U.S. Supreme Court in *Northwest Bank Worthington v. Ahlers*, 485 U.S. 197 (1988), which was binding precedent at the time of the malpractice trial.

iii. The debtors also challenged the trial court's exclusion of expert testimony about the local bankruptcy judge's proclivity to confirm almost every farm reorganization plan. The Eight Circuit concluded that the jury in a malpractice case is permitted to substitute its own judgment about the outcome of the underlying bankruptcy for the judgment of the factfinder. An approach of "[r]econstructing the probable behavior, thought process, and attitude of the judge in the earlier case is neither necessary, nor prudent." *Id.* at 957.

(d) In *In re VWE Group, Inc*., 359 B.R. 441 (S.D.N.Y. 2007), the unsecured creditors' committee asserted a malpractice claim against the debtor's former lawyers "based on their alleged failure to advise the [d]ebtor to seek Chapter 11 protection in a timely manner."

i. According to the committee's complaint, the defendants had "a duty to inform the [d]ebtor of all its options – one of which was the filing of a Chapter 11 petition – sooner rather than later, but failed to do so." *Id*. at 444. Had they provided "competent legal advice," the Debtor and its estate would have preserved more than $4.2 million.

ii. No decision on the merits. District court's decision is about timeliness of defendants' motion to remove the reference.

13. Appealing from final judgment or order. Rule 8002(a) provides for only a 14-day period to file a notice of appeal.

14. Other, nonbankruptcy deadlines that may be tolled or extended.

(a) Code section 108(a) provides the trustee with an extension of up to two years after the order for relief to commence any action for which the statute of limitations had not run as of the petition date.

(b) Code section 108(c) provides parties with no less than 30 days after the termination or expiration of the automatic stay to commence actions against the debtor if the statute of limitations had not run as of the petition date.

V. SUBSTANTIVE ERRORS.

A. Inadequate or improper advice concerning whether to file.

1. In *Bularz v. Hinkfuss*, 2004 WL 21070 (Wis. Ct. App. 2004) (unpublished opinion) the debtors claimed that a lawyer who defended them in prepetition litigation – which they settled for $40,000 – was "negligent by failing to advise them that this debt could have somehow been discharged under the bankruptcy code."

   (a) The Bularzes did eventually seek relief, filing under Chapter 7 in 2000 – about 3-4 years after the settlement.

   (b) They must have listed the malpractice claim on their schedules, because the trustee was included as a plaintiff in the litigation.

   (c) The trial court concluded that the Bularzes could not establish a *prima facie* case of legal malpractice without expert testimony, and dismissed their complaint.

   (d) The court of appeals affirmed, noting that "Bankruptcy is just the type of subject that . . . [is] not within the realm of the ordinary experience of [persons], and which requires special learning, study or experience." In order to prove that their litigation lawyer committed malpractice by negligently failing to advise them that a debt could have been discharged in bankruptcy, the Bularzes needed to provide expert testimony.

   (e) Although not mentioned in the court opinions, a PACER search reveals that the Bularzes filed a previous bankruptcy in 1993 and received a discharge – so perhaps they were already more familiar with the concept of discharge than their litigation lawyer. For what it's worth, they received their third Chapter 7 discharge through a case they filed in 2009.

2. In *Banks v. Hendershott*, 719 P.2d 484 (Or. App. 1986), a lawyer was found liable to his clients for administrative costs of $29,000 which they incurred by filing a bankruptcy on the lawyer's advice after losing certain property through strict foreclosure. The lawyer argued that there had been no evidence presented concerning the costs of other alternatives, but the court held that jury could conclude that one alternative was to do nothing, at zero cost, so the damages were reasonable. *Id.* at 487.

3. The debtor in *Enriquez v. Smyth*, 219 Cal. Rptr. 267 (Cal. App. 1985), also would have been much better off ignoring his attorney's advice to file bankruptcy.

   (a) In completing the schedules, the lawyer valued the debtor's home at $30,000, based on his own "experience." However, the lawyer failed to appear at the section 341 hearing, and the debtor testified that he believed his home was worth about $40,000.

(b) The trustee then objected to the debtor's homestead exemption and demanded that the debtor purchase the estate's interest in the home for $12,000 (even though the total claims were $6,000).

(c) The debtor took out an interest-only mortgage loan with a $17,000 balloon after two years, paid $12,000 to the trustee, and received $5,430 in cash. Living on a fixed income, the debtor was unable to make the balloon payment, and was forced to sell the home.

(d) The jury award of $15,000 against the lawyer was affirmed. The expert testimony established that the case should not have been filed and that obtaining an appraisal or seeking a dismissal were viable alternatives that were never explained to the client.

B. Which chapter to use.

1. In *Swanson v. Sheppard*, 445 N.W.2d 654 (N.D. 1989), the debtor's lawyer failed to advise his client that student loans were dischargeable in a Chapter 13 bankruptcy, but not in Chapter 7. Damages were calculated by the amount of the student loans, less the payments the debtor would have made under his hypothetical Chapter 13 plan.

2. In *In re Alvarez,* 224 F. 3d 1273 (11th Cir. 2000), the debtor filed a malpractice complaint against his former bankruptcy lawyers, alleging that they "negligently disregarded his instructions" to file a Chapter 11 case, and instead filed a Chapter 7.

(a) The debtor filed the case in Florida state court, and the defendants removed it to bankruptcy court. The parties' first trip to the Eleventh Circuit involved appeals from denial of remand or abstention.

(b) The second time around, the debtor was appealing from the district court's dismissal of the complaint because the malpractice claim belonged to the bankruptcy estate. The Court of Appeals affirmed.

(c) Interesting discussion of whether a cause of action is pre- or post-petition when the harm to the debtor occurs "at the moment of the bankruptcy filing."

3. Similarly, *In re Strada Design Associates, Inc.,* 326 B.R. 229 (Bankr. S.D.N.Y. 2005), involved a malpractice lawsuit based on allegations by the debtors' principals that their lawyer "pressured" them to "follow a Chapter 7 route" without explaining that they would lose control of their companies.

C. Failure to schedule debt, resulting in its nondischarge. In *Birbenstine v. Woodworth*, 278 N.W.2d 41 (Mich. 1979), despite the debtor's repeated requests to schedule a debt owed to the Michigan Motor Vehicle Accident Claims Fund, the bankruptcy lawyer neglected to do so. No decision on the merits, but the court found that the statute of limitations defense was inapplicable because it did not begin to run until the general discharge was granted.

D. Asset transfers and exemption planning.

1. The attorneys in *Lambert v. Stark*, 484 N.E.2d 630 (Ind. App. 1985), advised their clients to transfer certain property for less than reasonably equivalent value. As a result, the debtors were denied a discharge. The malpractice claim against the attorneys was dismissed based on the court's conclusion that the two-year statute of limitations began running before the denial of discharge.

2. Although not a bankruptcy case, *Makela v. Roach*, 492 N.E.2d 191 (Ill. App. 1986), is also instructive. The client hired an attorney to execute a scheme for stripping marital assets from her sick husband in order to keep the money from medical creditors. When the transferees failed to use the assets to support the client and her husband as planned, the client sued the lawyer for malpractice. The court refused to consider her claim because of the "unclean hands" doctrine.

3. On the other hand, a lawyer can certainly commit malpractice by failing to fully to investigate all available exemptions and neglecting to engage in reasonable pre-bankruptcy planning.

4. The tension was noted by the court in *In re Warren*, 512 F.3d 1241 (10th Cir. 2008): "[B]ankruptcy lawyers can face a dilemma in advising clients whether to acquire exempt assets. As one commentator observed, '[T]he same conduct can be malpractice <u>not</u> to advise in one jurisdiction, but voidable and grounds for denial of discharge and possibly for disbarment in another . . . .'" *Id.* at 1249, *quoting* John D. Ayer, *How to Think About Bankruptcy Ethics*, 60 Am. Bankr. L.J. 355, 374 (1986).

E. Not knowing the law. In *Patterson v. Smith, May, Smith & Anderson*, 473 N.W. 2d 94 (Neb. 1991), the attorney advised the Chapter 11 farmers to use cash collateral to pay operating expenses, even though the secured lender had not consented and the court had not authorized such usage.

1. After a plan was proposed, the lender obtained relief from the stay based on the unauthorized use of $70,000 in cash collateral.

2. A less favorable plan was then proposed and confirmed.

3. A jury verdict of $1.1 million against the attorney was vacated and a new trial was ordered. The appellate court remanded with instructions to dismiss, finding that there was no reliable evidence of damages because the debtors' expert witness had not stuck to the original plan for purposes of comparison to the confirmed plan.

F. Perfection problems.

1. The attorneys in *Theobald v. Byers*, 13 Cal. Rptr. 864 (Cal. App. 1961) failed to advise their client how to perfect a chattel mortgage so the client was an unsecured creditor, rather than being fully secured, in the subsequent bankruptcy proceeding of the borrower.

2. The $92.0 million typo case. *Prudential Ins. Co. of America v. Dewey Ballantine, Bushby, Palmer & Wood*, 170 A.D.2d 108, 573 N.Y.S.2d 981 (App. 1991).

   (a) Amount of secured lender's Preferred Ship Mortgage erroneously typed as $92,885.00 rather than $92,885,000.00

   (b) When the borrower filed bankruptcy, lender sought relief from the stay to foreclose on a fleet of ships. The mistaken mortgage was challenged, and the dispute was settled by the lender agreeing to pay the estate 17.5% of the proceeds from sale of the ships.

3. In *Schultze v. Chandler*, 765 F.3d 945 (9th Cir. 2014), a debtor confirmed a Chapter 11 plan based on a sale of assets. Debtor's counsel negotiated the sale and failed to file a UCC statement to perfect the estate's junior lien in the property being sold.

   (a) The buyer defaulted, and original debtor's creditors were impaired by the non-perfection.

   (b) The representatives of the estate brought a malpractice claim in state court against the attorney for the unsecured creditors' committee.

   (c) The lawyer removed the case to bankruptcy court, which dismissed the claim because the committee's lawyer owed no duty to the debtor or its estate.

   (d) Both the district court and the Ninth Circuit affirmed, including that the bankruptcy court had jurisdiction over the lawsuit as a core proceeding. *Id*. at 950.

G. Counseling or condoning fraud. In *Evans v. Cameron*, 121 Wis. 2d 421 (1985), the debtor was denied a discharge for falsely stating under oath at the section 341 meeting that she had transferred away $10,000 in cash. She claimed her attorney had advised her to lie; he denied it. The Wisconsin Supreme Court directed that her complaint be dismissed (without leave to amend) under the doctrine of *in pari delicto*.

H. Inaccurate or incorrect schedules. In *Reinke v. Dempsey, Williamson, Lampe, Young, Kelly & Herrtel, LLP*, 2007 WI App. 34 (Wis. Ct. App. 2007) (unpublished opinion), the debtor's underlying Chapter 13 case was dismissed upon a finding of bad faith misconduct, principally because of inaccuracies in the schedules.

1. The debtor sued her bankruptcy attorneys for malpractice, claiming that they knowingly submitted her false schedules.

2. The trial court granted summary judgment in favor of her lawyers, concluding that the debtor was "equally at fault" for the unsuccessful bankruptcy petition.

3. The court of appeals affirmed on causation grounds. A defense expert testified that no Chapter 13 plan could have been confirmed because the debtor had not filed her tax returns for the previous two years. The debtor therefore could not show that her lawyers' negligence was a substantial factor in her failed Chapter 13 case.

VI. WHOSE ASSET IS IT?

A. Does a debtor's claim for legal malpractice belong to the bankruptcy estate? At least three Courts of Appeal have addressed this question.

1. *In re Alvarez*, 224 F.3d 1273 (11th Cir. 2000).

(a) The debtor filed a legal malpractice action against his lawyers in state court, alleging that they negligently disregarded his instructions to file a Chapter 11 case on his behalf, and had instead filed under Chapter 7.

(b) The lawyers removed the case to the bankruptcy court and unsuccessfully argued that the claims were property of the estate. On appeal, the district court reversed.

(c) After analyzing the issue under both state (Florida) and federal law, the Eleventh Circuit decided that the cause of action was "sufficiently rooted in [the debtor's] pre-bankruptcy past that it should be considered property of [the debtor] as of the commencement of his bankruptcy case, and thus property of his estate." *Id*. at 1279.

(d) A concurring judge compared the question to a flipped coin that lands on its edge. "When the petition is filed, the estate is instantly created but the alleged tort is also completed. If the filing injures the plaintiff, how can the claim be a part of the estate *as of* the commencement of the case? [But] how can . . . the plaintiff be said to have been injured *after* the commencement of the case, when the last act producing injury coincides with the estate creation?" *Id*. at 1280 (Hill, C.J., concurring dubitante) (emphasis in original).

2. *In re Wheeler*, 137 F.3d 299 (5th Cir. 1998).

(a) The debtor signed false schedules prepared by his lawyer. About five years after receiving his discharge, the debtor was indicted and convicted of bankruptcy fraud.

(b) He brought a malpractice claim against his bankruptcy lawyer, and the bankruptcy court determined that the cause of action belonged to the trustee. The debtor argued that the cause of action did not "accrue" until he was convicted postpetition, so the claim was not property of the estate.

(c) The district court and Fifth Circuit affirmed: "Wheeler should have discovered any discrepancies between his actual assets and those listed on his bankruptcy [schedules] at the time he signed the petition." *Id.* at 301. He thus should have learned of the existence of malpractice prepetition, so the cause of action accrued prepetition.

3. *In re O'Dowd*, 233 F.3d 197 (3rd Cir. 2000).

(a) Anne O'Dowd was represented by Lawyer A in a real estate transaction that turned out to be a financial disaster, driving her into Chapter 11 bankruptcy. She retained Lawyer B to represent her in the bankruptcy, and to bring a malpractice action against Lawyer A.

(b) Her case ultimately converted to Chapter 7. Due to ethics charges in an unrelated matter, Lawyer B resigned and was replaced by Lawyer C.

(c) The trustee tried to settle the malpractice lawsuit for $10,000. The court denied the settlement, allowing O'Dowd to pursue the action herself and pay the estate the first $10,000 of any recovery.

(d) O'Dowd then discovered that Lawyer B had omitted a number of claims in the lawsuit, which were now time-barred. She brought a second malpractice action against Lawyer B and Lawyer C (for not timely advising her about Lawyer B's mistakes).

(e) Lawyer C moved to dismiss that action on the grounds that it belonged to the bankruptcy estate; O'Dowd argued that because the misconduct occurred postpetition, the resulting claim was not property of the estate.

(f) The Third Circuit affirmed the district court's conclusion that the second malpractice claim *was* property of the estate, because it was "conceptually impossible to sever" the first and second malpractice actions, and because both actions were traceable directly to O'Dowd's prebankruptcy dealings with" Attorney A.

B. Depends when the claim arises, which depends on when the injury occurs.

1. Does the cause of action exist as of the moment that the malpractice is committed? When it was discovered or should have been discovered?

2. Or . . . does the cause of action only arise when the client suffers actual damages (such as an adverse judgment, or denial of discharge) because until then, the lawyer might be able to cure the problem?

3. Courts seem to have settled on the "sufficiently rooted in the debtor's pre-bankruptcy past" standard used in *Alvarez*, supra. See, for example:

(a) *In re Almasri*, 378 B.R. 550 (Bankr. N.D. Ohio 2007). Debtor had discharge revoked for failure to disclose a bank account and business. He claimed his bankruptcy lawyer was informed about these

assets and omitted them from the schedules. The trustee then filed an adversary proceeding against debtor's lawyer for malpractice. The court determined that the claims were sufficiently rooted in the debtor's prebankruptcy and therefore belonged to the estate. The lawyer's motion to dismiss for lack of standing was denied.

(b) Similarly, in *In re Alipour*, 252 B.R. 230 (Bankr. M.D. Fla. 2000), the court concluded that "[T]he 'accrual' of a cause of action for purposes of determining the trigger date for the statute of limitations may be different from the 'accrual' of the action for purposes of determining whether the claim constitutes property of a bankruptcy estate . . . For purposes of section 541, the test is whether all of the elements of the cause of action had occurred as of the time that the bankruptcy case was commenced, so that the claim is sufficiently rooted in the debtor's prebankruptcy past. *Id.* at 235.

4. An analogous issue arose in *Williamson v. Hi-Liter Graphics*, LLC, 2012 WI App 37 (Ct. App. 2012).

(a) The plaintiff filed a lawsuit based on alleged misrepresentations that occurred prior to his personal bankruptcy, but that he did not discover until more than a year after filing.

(b) The defendant moved to dismiss, arguing that the claims belonged to the bankruptcy estate and plaintiff lacked standing to assert them.

(c) The trial court applied federal law and concluded that the claim was "sufficiently rooted" in the plaintiff's prebankruptcy past and accordingly belonged to his bankruptcy estate.

(d) The court of appeals affirmed. Wisconsin's "discovery of injury" rule could not be used by the plaintiff/debtor "to usurp the right of the federal bankruptcy estate to bring [the fraud] action."

C. It also depends on whether the asset lost as a result of malpractice would have been exempt. "Courts have consistently found that legal malpractice actions which replace exempt assets are themselves exempt." *In re Saunders*, 2003 Bankr. LEXIS 1819 at *16 (Bankr. S.D. Fla. 2003) (unpublished) and cases cited therein.

D. Malpractice claims that were not identified on the client's bankruptcy schedules can later be defeated under the doctrines of judicial estoppel or res judicata. *See, e.g., Dana Investment Corp. v. Robinson & Cole*, 2001 WL 283446 (Conn. Superior Ct. 2001) (unpublished opinion) ("Having obtained relief from the bankruptcy court without disclosing the cause of action now pressed in this case, plaintiff is precluded from now resurrecting the claims by the doctrine of judicial estoppel"); *Southmark Corp. v. Trotter, Smith & Jacobs*, 212 GA. App. 454, 442 S.E.2d 265 (Ga. App. 1994) ("In the light of the stringent disclosure requirements under Chapter 11, the failure to disclose [the existence of malpractice claims] is viewed as amounting to a denial that such claims exist."). *See also Dana Investment*

Corp. Bankruptcy Estate v. Robinson & Cole, 2003 WL 231675 (Conn. Superior Ct. 2003) (unpublished opinion) (plaintiff again rebuffed when it re-filed the suit in the name of the bankruptcy estate).

E. But where a malpractice claim has been properly disclosed on a debtor's schedules, and the trustee abandons the claim, the debtor may thereafter pursue it for his or her own benefit – unless the trustee changes his mind.

1. In *Mrozek v. Intra Financial Corp*., 281 Wis. 2d 446 (2005), the plaintiffs (a company and its owner) brought malpractice claims against their former lawyers for faulty business advice that had allegedly forced the company into bankruptcy.

(a) The schedules listed a potential claim against the law firm for negligent delivery for legal services.

(b) After the assets were sold, the Chapter 11 case was converted to Chapter 7. The trustee filed a no-asset report, with the standard notation that the report "shall be considered as an abandonment of all scheduled property of the bankruptcy estate."

(c) The court of appeals held that the malpractice claims were barred by claims preclusion and had been "lost" because the trustee did not proceed on them.

(d) The Supreme Court reversed on this issue. It thoroughly analyzed the relevant Bankruptcy Code provisions and federal precedents, and concluded that closure of the case had operated as abandonment, which revested the malpractice claims in the plaintiffs.

2. Compare that process to what happened in *In re Wolff*, 2010 Bankr. LEXIS 13, 2010 WL 27335 (Bankr. N.D. Ill. 2010).

(a) The lawyer for a Chapter 11 debtor allegedly put up a poor defense to a lift-stay motion and then negligently failed to appeal. The case, of course, converted.

(b) Some question whether the potential malpractice claims was scheduled, but the trustee was aware of it and considered it of no value. He filed a no-asset report and closed the case.

(c) The debtors brought a malpractice suit in state court. The lawyer-defendant argued for dismissal because the claims were property of the bankruptcy estate.

(d) The debtors reopened their bankruptcy case, and the same trustee was reappointed. He decided to auction the claims, which was then rephrased as a bidding process to "compromise" the claims since legal malpractice claims are non-assignable under Illinois law.

(e) The lawyer was the high bidder, and the bankruptcy court approved the compromise over the debtors' objection.

(f) Strangely, the bankruptcy judge acted as a sort of witness. Having presided over the lift-stay hearing, he commented upon the low likelihood that the debtors would succeed in proving negligence by their Chapter 11 lawyer.

F. What about prepetition malpractice claims of a freshly reorganized Chapter 11 debtor against its bankruptcy counsel? In *In re National Benevolent Association of Christian Church (Disciples of Christ)*, 333 Fed. Appx. 822 (5th Cir. 2009) (unpublished opinion), the debtor sued its bankruptcy lawyers for malpractice, contending that counsel had failed to appropriately advise it of the potential negative consequences of filing a petition (being forced to liquidate its senior care living centers as part plan confirmation negotiations).

1. Although a reorganization plan was confirmed, the debtor argued that its counsel's prepetition negligent advice created unnecessary professional fees in the bankruptcy case and prevented it from reaching a more favorable out-of-court resolution and thereby avoiding bankruptcy.

2. The court held that because the confirmed plan's provisions failed to specifically and unequivocally reserve the right to prosecute its claim against its counsel arising out of the alleged prepetition malpractice conduct, the reorganized debtor lacked standing to pursue such claims. *See also In re United Operating, LLC*, 540 F.3d 351, 355 (5th Cir. 2008).

G. The malpractice claim might even belong to a secured creditor. In *Attorney's Title Guaranty Fund, Inc. v. Town Bank*, 20114 WI 63, 850 N.W.2d 28 (2014), the Supreme Court held that proceeds of a legal malpractice claim are assignable, and resolved a dispute over which of two creditors had priority. The Court punted on the question of whether the malpractice claim itself can be assigned, but noted the concerns of other courts and acknowledged that 18 other states prohibit such assignments.

VII. WHERE CAN/SHOULD THE CLAIMS BE HEARD?

A. Extremely complicated question at multiple levels.

1. Is the claim core or non-core?

2. Even if it's core, is it constitutional for the bankruptcy court to enter a final order under *Stern v. Marshal*, 564 U.S. 2 (2011)?

3. Should the bankruptcy or district court abstain, and let the state courts decide these state law claims? Who is better equipped to decide the substantive questions?

(a) We are, says the bankruptcy judge in *In re Central Illinois Energy L.L.C.*, 2010 WL 2491019 (Bankr. C.D. Ill. 2010):

"True, a claim for legal malpractice is a state law tort action for negligence based upon an attorney's failure to exercise a reasonable degree

of skill and care in representing his client. [But the issue of what rights the debtor lost by filing Chapter 11] is largely a question of bankruptcy law, and an unsettled one to boot. The better forum for the resolution of that critical issue is the bankruptcy court."

(b) *In re the VWE Group, Inc*., 359 B.R. 441, 449 (S.D.N.Y. 2007):

"Apparently, it is plaintiff's position that only a Bankruptcy Court can determine whether a law firm's failure to advise a corporation to declare bankruptcy at a particular point in time . . . is or is not malpractice. But that is absurd."

B. Defendants seem generally inclined to remove cases against them from state court to the bankruptcy court.

1. Is it because the bankruptcy judge witnessed the lawyer in action, and will apply his or her own impressions of the lawyer's conduct to the matter?

2. Another possibility: Lawyers remove malpractice claims to the bankruptcy court in which they allegedly occurred because their prior award of fees by that court will operate as res judicata or claim preclusion. *See Capitol Hill Group v. Pillsbury, Winthrop, Shaw, Pittman, LLC*, 569 F.3d 485 (D.C. Cir. 2009) (res judicata bars claims of negligence against debtor's former Chapter 11 counsel because the issue had to be litigated in connection with earlier fee disputes); *Grausz v. Englander*, 321 F.3d 467 (4th Cir. 2003) (final fee application "necessarily involved an inquiry by the bankruptcy court into the quality of professional services rendered by the [defendant] firm," and therefore precluded later malpractice claim by the debtor); *Iannochino v. Rodolakis*, 242 F.3d 36 (1st Cir. 2001) (debtors' malpractice claims against their Chapter 13 lawyer were barred because they failed to object to his fee application and award for pre-conversion legal services).

C. For a case with nightmarish jurisdictional issues and disputes, see *In re C and M Properties, L.L.C.*, 563 F.3d 1156 (10th Cir. 2009). Comparing the case to that of *Jarndyce v. Jarndyce* in Charles Dickens' *Bleak House*, the Court commented that "It's been more than four years since any federal judge had authority to hear this case. Even so, the litigation grinds on. Before the bankruptcy and district courts, the parties have bloodied each other in round after round of motions and arguments through year after year."

VIII. AVOIDING MALPRACTICE IN BANKRUPTCY

A. Carefully screen all clients, especially debtors. You <u>can</u> afford to be selective; or stated differently, you cannot afford not to be selective.

B. Have a fail-safe calendar system that is sophisticated enough to cover the plethora of deadlines involved in bankruptcy cases. Missed deadlines are the easiest type of malpractice to avoid, yet among the most common to occur.

C. Keep current with the law.

D. Communicate frequently with the client, and reduce all understandings (fees, authority to settle, scope of representation, etc.) to writing.

E. Know your limitations.

F. One (disappointing) viewpoint from a malpractice insurer: If you're in Chapter 11, litigate everything.

> "Lawyers need to be sensitive to hindsight claims of delay, especially in high-stakes Chapter 11 cases. They should consider taking early affirmative action to enforce clients' rights, rather than taking a reactive approach to the bankruptcy process. Many bankruptcy attorneys attempt to craft case-specific strategies that sometimes involve attempts to negotiate solutions to disputes before resorting to litigation. If the strategy fails, the lawyer may be subjected to second guessing of legitimate tactics by their clients or other participants in the bankruptcy process. Accordingly, lawyers should consider filing available motions or other necessary pleadings before engaging in negotiations." (Commentary in a newsletter issued by a malpractice insurer).