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# How to Minimize Your Business Bankruptcy Practice Malpractice Risk


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# THE WHO, WHERE, AND WHEN OF BANKRUPTCY LEGAL MALPRACTICE CLAIMS

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# THE WHO, WHERE, AND WHEN OF BANKRUPTCY LEGAL MALPRACTICE CLAIMS

## I. INTRODUCTION

It is not uncommon for legal malpractice claims to be asserted against attorneys in connection with their professional services rendered in the context of a bankruptcy proceeding. When such claims are asserted, three questions must be addressed:

1. Who owns the claim?
2. Where should the lawsuit be filed?
3. When should the lawsuit be filed?

## II. WHO OWNS THE CLAIM?

The answer to the question of who owns the claim determines who has standing to assert the claim. Resolving this inquiry depends in the first instance on when the cause of action accrued. However, the answer also varies depending on whether the bankruptcy proceeding arises in the context of Chapter 7 or Chapters 11, 12, or 13, whether the debtor is an individual or a corporation or other business entity, and whether the legal malpractice claim was scheduled and/or administered in the bankruptcy proceeding.

### A. Is the Legal Malpractice Claim Property of Estate?

"In bankruptcy, as in life, timing can be everything." *In re Cantu*, 784 F.3d 253, 255 (5th Cir. 2015).

Generally speaking, if a legal malpractice claim that would normally belong to the debtor arises before the filing of bankruptcy, the cause of action belongs to the bankruptcy estate. The determining factor on this timing question is when the debtor's cause of action accrued under state law. *Id.* at 258 (citing *State Farm Life Ins. Co. v. Swift*, 129 F.3d 792, 795 (5th Cir. 1997)). Other circuits follow this accrual approach. *See, e.g.*, *O'Dowd v. Trueger*, 233 F.3d 197, 203 (3rd Cir. 2000) (applying New Jersey law); *In re Alvarez*, 224 F.3d 1273, 1276-77 (11th Cir. 2000) (applying Florida law).

In *Cantu*, the debtors sued their bankruptcy attorney for malpractice in state court. The state court case was later removed to federal court, and eventually the debtors and the attorneys settled for $281,710.54, which was deposited into the registry of the court pending determination of whether the settlement proceeds belonged to the debtors or to the bankruptcy estate. The parties agreed that the alleged acts and omissions giving rise to the malpractice claim occurred during the pendency of the debtors' Chapter 11 proceeding, a proceeding that was subsequently converted to Chapter 7. The debtors argued that, under state law, the cause of action did not accrue until the wrongful acts caused an injury and that the injury they suffered occurred after conversion to Chapter 7 when their assets were liquidated and the bankruptcy court denied their discharge. Notwithstanding that the debtors suffered direct injury as a result of the denial of their discharge, the trustee argued that the bankruptcy estate itself suffered injury prior to conversion. The Fifth Circuit, relying on Texas law, concluded that the alleged malpractice of the attorney injured the Chapter 11 bankruptcy estate such that the trustee (or debtor-in-possession) would have been in a position to file the lawsuit prior to conversion. The court held that the claim was therefore an asset of the Chapter 7 bankruptcy estate and could be prosecuted only by the Chapter 7 trustee.

In the context of a Chapter 7 case (whether an original filing or a conversion from some other chapter), there is a fairly bright line that determines ownership of a debtor's legal malpractice claim – before and after commencement of the case. If the debtor's cause of action accrued before commencement of the bankruptcy, the claim belongs to the estate. If the debtor's cause of action accrued after commencement of the bankruptcy, the claim belongs to the debtor. In the context of Chapters 11, 12, and 13, and in the context of a legal malpractice claim of a Chapter 7 trustee[1], that bright line does not exist because, pursuant to 11 U.S.C. § 541(a)(7), property of the estate also includes "[a]ny interest in property that the estate acquires after the commencement of the case." A legal malpractice claim accruing after commencement of a Chapter 11, 12, or 13 proceeding (and arguably a legal malpractice claim of a trustee accruing after commencement of a Chapter 7 proceeding) also becomes property of the bankruptcy estate.

There may be one exception to this rule that applies to individual Chapter 7 debtors who claim exempt property. If the attorney's malpractice results in injury to an otherwise exempt asset of the debtor, the claim may belong to the debtor even if the cause of action accrued prior to the bankruptcy filing. "Courts have consistently found that legal malpractice actions which replace exempt assets are themselves exempt." *In re Saunders*, 2003 WL 23239155, *5 (Bnkr. S.D. Fla. Dec. 10, 2003).

**B. What Happens When the Case is Over?**

**1. <u>Chapter 7 Proceedings</u>**

In the context of a Chapter 7 proceeding, a legal malpractice claim that has been properly scheduled as an asset in the bankruptcy is abandoned back to the debtor if the claim is not "administered" by the trustee. 11 U.S.C. § 554(c). The debtor would then once again become the owner of the claim entitled to bring suit. *See, e.g., Mrosak v. Intra Financial Corp.,* 281 Wis.2d 446 (2005) (holding that trustee's failure to administer a scheduled prepetition legal

[1] No reported cases of Chapter 7 trustees suing their own attorneys were located, but logically it would follow that any claim for malpractice by the attorney for the trustee that resulted in injury to the bankruptcy estate would become an asset of the bankruptcy estate.

malpractice claim resulted in abandonment of that asset back to the debtor). But Section 554(c) expressly applies *only* to "property scheduled under Section 521(a)(1)." Section 521(a)(1), of course, requires that the debtor file, among other things, "a schedule of assets and liabilities." Aside from any estoppel defenses a debtor might face as a result of failing to properly disclose the malpractice claim as an asset, a claim would arguably not be subject to abandonment by operation of law under Section 554(c) if it is not included in the bankruptcy schedules. The claim would therefore remain an asset of the bankruptcy estate, but an asset not administered and simply left in limbo.

**2. <u>Chapter 11, 12, and 13 Proceedings</u>**

In the context of a Chapter 11, 12, or 13 proceeding, the Bankruptcy Code provides that "[e]xcept as otherwise provided in the plan or the order confirming the plan, the confirmation of a plan vests all of the property of the estate in the debtor." 11 U.S.C. §§ 1141(b), 1227(b), and 1327(b). These provisions would seem to indicate that any legal malpractice claim that was property of the estate would vest back in the debtor upon confirmation of a plan. However, several courts have held that "the *res judicata* effect of the order confirming the plan may preclude a debtor's pursuit of a cause of action post confirmation if that cause of action was not preserved in the plan . . .." COLLIER ON BANKRUPTCY ¶ 1141.03 (16th ed.)

Specifically, the Fifth Circuit has held that:

> . . . in some cases the Code allows a reorganized debtor to bring a post-confirmation action on a "claim or interest belonging to the debtor or to the estate." 11 U.S.C. § 1123(b)(3). A debtor may preserve its standing to bring such a claim (*e.g.*, for fraud or breach of fiduciary duty,[2] or to avoid a preferential transfer[3]) but only if the plan of reorganization expressly provides for the claim's "retention and enforcement by the debtor." § 1123(b)(3)(B). "After confirmation

[2] *In re Avado Brands, Inc.*, 358 B.R. 868, 883 (Bankr.N.D. Tex. 2006).
[3] *Harstad v. First American Bank*, 39 F.3d 898, 901-02 (8th Cir. 1994).

> of a plan, the ability of the [debtor] to enforce a claim once held by the estate is limited to that which has been retained in the plan." *In re Paramount Plastics, Inc.*, 172 B.R. 331, 333 (Bankr.W.D.Wash. 1194); *see also In re Tex. Gen. Petrol. Corp.*, 52 F.3d 1330, 1335 n.4 (5th Cir. 1995) (citing *Harstad*, 39 F.3d at 902-03). For a debtor to preserve a claim, "the plan must expressly retain the right to pursue such actions." *Paramount*, 172 B.R. at 333. The reservation must be "specific and unequivocal." *Harstad*, 39 F.3d at 902; *see also Ice Cream*, 319 B.R. at 337-38 (holding that the plan's categorical reservation of "preference" claims was sufficiently specific; plan need not itemize individual transfers that may be pursued as preferential). If a debtor has not made an effective reservation, the debtor has no standing to pursue a claim that the estate owned before it was dissolved.

*In re United Operating, LLC*, 540 F.3d 351, 355 (5th Cir. 2008). This holding has been expressly applied to legal malpractice claims. *See, In re National Benevolent Assoc. of the Christian Church (Disciples of Christ)*, 333 Fed. Appx. 822, 827 (5th Cir. 2009) (holding that reorganized debtor lacks standing to bring malpractice claim based on prepetition malpractice "unless the confirmed plan specifically and unequivocally reserved these claims.").[4]

The rationale for these decisions appears to be that "absent specific and unequivocal retention language in the plan, creditors lack sufficient information regarding their benefits and potential liabilities to cast an intelligent vote." *In re Tex. Wyo. Drilling, Inc.*, 647 F.3d 547, 550 (5th Cir. 2011). This is an estoppel argument. It is interesting to note, however, that none of these cases even mention 11 U.S.C. § 1141(b), which on its face provides for vesting of all assets of the estate in the debtor "except as otherwise provided in the plan." It is also interesting to note that the Fifth Circuit's seminal case on this estoppel argument relies heavily on (and quotes extensively from) *In re Paramount Plastics, Inc.*, 172 B.R. 331 (Bankr. W.D. Wash. 1994). In *Paramount*, the bankruptcy court held that the reorganized debtor could not prosecute preference

[4] *National Benevolent Assoc.* is an interesting case because the debtor's plan did expressly preserve claims against "Professionals," but the court construed that the preservation of claims language in the plan to be limited to post-petition legal services. *Id.* at 828.

actions post-confirmation in the absence of "specific and unequivocal" retention language in the plan. *Id.* at 335. The basis of the court's holding was that:

> [b]ecause the confirmation of a Chapter 11 plan dissolves the bankruptcy estate and the rights and powers created under the Bankruptcy Code, the retention provision of § 1123(b)(3)(B) requires specific and unequivocal language of reservation. Without this language, the avoidance powers of the Trustee streaming from the Bankruptcy Code at §§ 544, 547, 548, 549 and 550 perish and become unenforceable.

*Id*. at 334 (quoting *In re Mako, Inc.*, 120 B.R. 203, 209 (Bankr. E.D. Okl. 1990).[5]

So on its face, the holding in *Paramount* is limited to claims arising out of a trustee's avoidance powers – powers that exist only under the Bankruptcy Code and that "perish and become unenforceable" upon plan confirmation unless expressly preserved. But of course, a legal malpractice claim has nothing to do with a trustee's avoidance powers, and the claim exists independent of any provision of the Bankruptcy Code. A legal malpractice claim is simply a tort arising under state law.

One of the more recent Fifth Circuit cases dealing with this issue, *Wooley v. Haynes & Boone, LLP*, 714 F.3d 860 (5th Cir. 2013), follows the precedent of *United Operating* and *Texas Wyoming* in holding that a debtor lacks standing to bring a legal malpractice claim in the absence of a specific reservation in the confirmed plan. The holding in that case seems to be based on two principles. The first is that "[d]uring the Chapter 11 case, the enforcement of [causes of action belonging to the debtor] generally falls to the debtor-in-possession, which has 'most of the powers of a bankruptcy trustee to pursue claims on behalf the estate.'" *Id.* at 864 (citing *In re*

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[5] The court in *Paramount* expressly rejected the argument that the revesting provision in 11 U.S.C. § 441(b) allowed the reorganized debtor to pursue avoidance action, holding instead that:

> While section 1141(b) may aid [the court] in determining what assets remain property of the estate, *it has nothing to do with retention of preference actions*. [Citation omitted] . . .. Congress specifically enacted section 1123(b)(3)(B) for that purpose. Any other interpretation of the Code would render section 1123(b)(3)(B) nugatory.

*Id.* at 334 (quoting *In re Harstad*, 155 D.R. 500, 510 (Bankr.D.Minn. 1993)) (emphasis added).

*United Operating, LLC*). And the second is that "[w]hen a Chapter 11 plan is confirmed . . . the estate ceases to exist, and the debtor loses its status as debtor-in-possession along with *its authority to pursue claims as though it were a trustee.*" *Id.* (emphasis added). Loss of debtor-in-possession status and loss of authority to pursue claims as though it were a trustee may be highly relevant to the issue of whether the debtor has post-confirmation standing to pursue an avoidance claim that exists only by virtue of the Bankruptcy Code. But what bearing does that have on the debtor's post-confirmation standing to pursue a simple tort claim that is an asset of the estate when Section 1141(b) says that such a claim vests in the debtor, "except as otherwise provided in the plan"?

Undoubtedly, the best course of action is to include language in the plan expressly preserving any legal malpractice claims the debtor may have. [See Panel's list of most common mistakes made by bankruptcy practitioners.] However, if confronted with the situation where a legal malpractice claim was scheduled or otherwise disclosed, but not expressly preserved in the plan, it would be worth considering whether Section 1123(b)(3)(B) should be interpreted to require express preservation of a claim only when the claim is one that would otherwise "perish" upon plan confirmation. Arguably, the debtor should have standing to bring a claim that exists independent of the Bankruptcy Code by virtue of the vesting provision in Section 1141(b), particularly given that Section 1123(b)(3)(B) provides only that a plan "may" provide for the retention of claims.

## III. WHERE SHOULD THE LAWSUIT BE FILED?

Once it has been determined who has standing to bring a claim for legal malpractice, the question remains as to where the claim should (or may) be brought. Generally speaking, the plaintiff can bring his or her legal malpractice action in state court. After all, a claim for legal malpractice is a state law cause of action, and no less so because the malpractice was committed in the context of a bankruptcy proceeding.

With respect to a Chapter 7 debtor's cause of action that is not property of the bankruptcy estate, state court may be the only option – barring some non-bankruptcy related basis for federal court jurisdiction. But with respect to both pre-and post-petition claims that are assets of the bankruptcy estate, the case law is clear that federal jurisdiction also exists. *See Grausz v. Englander*, 321 F.3d 467, 471-72 (4th Cir. 2003) (holding that under 718 U.S.C. § 1334(b) "'arising in' jurisdiction surely means that jurisdiction exists over a malpractice claim against a lawyer for providing negligence advice to a debtor in a bankruptcy case"); and *Mosier v. Callister, Nebeker & McCullough*, 2007 WL 951549 *2 (D. Utah 2007) (holding that federal court had "related to" jurisdiction under 28 U.S.C. § 1334(b) with respect to debtor's prepetition legal malpractice claim); *In re Central Illinois Energy, L.L.C.*, 2010 WL 2491019 (Bankr. C.D. Ill. 2010) (holding that "a debtor's claim of legal malpractice against nonbankruptcy counsel for advice, acts or omissions that occurred prepetition and pertained only to a nonbankruptcy issue, only falls within "related to" jurisdiction, even though the claim is an asset of the estate that a bankruptcy trustee could prosecute for the benefit of creditors as a non-core proceeding"). Thus, filing the lawsuit in federal court/bankruptcy court is also an option, and, if the lawsuit is initially filed by the plaintiff in state court, the defendant may have the option of removing the case to federal court.

The case of *Schultze v. Chandler*, 765 F.3d 945 (9th Cir. 2014), is illustrative. The controversy in *Schultze* arose from the failure of an attorney for the unsecured creditors' committee in a Chapter 11 bankruptcy to properly perfect a security interest in the debtor's property. *Id*. at 947. Specifically, the plan of reorganization in *Schultze* provided that the debtor would sell its business and assets to a third party and that all unsecured creditors were to receive a pro rata share of the proceeds. The third party made a down payment and executed a promissory note—secured in part by a junior lien on the debtor's personal property—for the balance. However, because the security interest in the personal property was never properly perfected, the third party was able to obtain additional credit, over-encumbering the debtor's assets and, ultimately, resulting in a greatly diminished recovery for the unsecured creditors when the third party defaulted on its payments under the note. Not surprisingly, the unsecured creditors brought suit against their attorney for malpractice in state court. The debtor's bankruptcy was reopened and converted to Chapter 7, dissolving the unsecured creditors' committee. The defendant attorney then removed the malpractice action to federal bankruptcy court, and the committee attempted, unsuccessfully, to remand the action to state court. The bankruptcy court dismissed the case against the defendant attorney because it found that he did not owe a duty to the plaintiff committee members individually; the district court affirmed. *Id*. at 948.

The Ninth Circuit was tasked with determining if the malpractice case was properly before the bankruptcy court. It determined that the bankruptcy court did indeed have jurisdiction over the removed legal malpractice case. The Court cited 18 U.S.C. 1334(b) for the proposition that "[a] bankruptcy court has jurisdiction over 'all civil proceedings arising under title 11, or arising in or related to cases under title 11'" and observed that "claims that arise under or in Title 11 are deemed to be 'core' proceedings…" *Id*. (quoting *Maitland .v Mitchell (In re Harris Pine Mills*), 44 F.3d 1431, 1435 (9th Cir. 1995)). The *Schultze* court further defined "arising in title 11" as those "matters 'that are not based on any right expressly created by title 11, but nevertheless, would have no existence outside of the bankruptcy." *Id*. (quoting *Maitland*, 44 F.3d at 1435). The Court pointed out that the appointment of the defendant attorney and his compensation were approved by the bankruptcy court; that "[h]is duties pertained solely to the administration of the bankruptcy estate;" and that "[t]he claim asserted…was based solely on acts that occurred in the administration of the estate." *Id*. at 969. With these factors in mind, the Ninth Circuit had little difficulty in determining that the bankruptcy court had jurisdiction to decide the legal malpractice claim, notwithstanding the fact that the claim was based on state law. Other Circuit courts taking up the matter are in agreement that bankruptcy courts have jurisdiction over malpractice suits against professionals hired in connection with bankruptcy proceedings.[6]

The case of *Grausz v. Englander*, 321 F.3d 467 (4th Cir. 2003), is also illustrative. In *Grausz*, the debtor sued his bankruptcy attorney for malpractice in state court. The attorney promptly removed the lawsuit to federal court, asserting bankruptcy jurisdiction under 28 U.S.C. § 1334. The attorney then moved for summary judgment based on *res judicata* resulting from court approval of his final fee application. The debtor moved to remand arguing that the district court lacked subject matter jurisdiction. The Fourth Circuit reaffirmed its prior holding in *A.H. Robins Co. v. Dalkin Shield Claimants Trust*, 86 F.3d 384 (4th Cir. 1996), that "claims of malpractice which originated out of pre- and post-petition advice of counsel concerning the *bankruptcy itself* are matters that fall within 'arising in' jurisdiction." *Id*. at 472.

The person with standing to bring a legal malpractice case that is an asset of the bankruptcy estate can bring the lawsuit in either state court or federal court. But if the plaintiff

[6] *Baker v. Simpson,* 613 F.3d 346, 350 (2nd Cir. 2010); *Grausz v. Englander,* 321 F.3d 467, 471 (4th Cir. 2003); *Southmark Corp. v. Coopers & Lybrand (In re Southmark Corp.),* 163 F.3d 925, 932 (5th Cir. 1999); *Billing v. Ravin, Greenberg & Zackin, P.A.,* 22 F.3d 1242, 1244 (3rd Cir. 1994); *Sanders Confectionery Prods., Inc. v. Heller Fin., Inc.,* 973 F.2d 474, 483 n. 4 (6th Cir. 1992).

chooses to file suit in state court, the defendant has the option of removing the case to federal court on the basis of either "arising in" jurisdiction for post-petition claims or "related to" jurisdiction for prepetition claims. It is beyond the scope of this article to discuss all the variables that might affect whether the lawsuit remains in federal court, including the possibility of motions for mandatory or permissive abstention.

## IV. WHEN SHOULD THE LAWSUIT BE FILED?

The answer to the question of when a legal malpractice lawsuit should be filed in the context of a Chapter 7 proceeding depends, of course, on the applicable state statute of limitations and when the cause of action accrued. If the claim is an asset of the bankruptcy estate, the Chapter 7 trustee gets the benefit of the two-year tolling provision in 11 U.S.C. § 108(a), which provides as follows:

> (a) If applicable nonbankruptcy law, an order entered in a nonbankruptcy proceeding, or an agreement fixes a period within which the debtor may commence an action, and such period has not expired before the date of the filing of the petition, the trustee may commence such action only before the later of (1) the end of such period, including any suspension of such period occurring on or after the commencement of the case; or (2) two years after the order for relief.

As such, the bankruptcy code itself will toll the statute of limitations for state legal malpractice claims the debtor had *before* the commencement of the bankruptcy proceeding. As discussed in Section II above, such claims belong to the bankruptcy estate. If the claim arises post-petition and is not an asset of the bankruptcy estate, the debtor does not get the benefit of tolling under 11 U.S.C. § 108(a) and must file any lawsuit within the applicable state statute of limitations.

The answer to this question in the context of a Chapter, 11, 12, or 13 proceeding also depends for practical reasons on whether the cause of action accrued pre- or post-petition, even though both categories of claims may be assets of the bankruptcy estate. The trustee or debtor-in-possession gets the benefit of tolling under 11 U.S.C. § 108(a) with respect to pre-petition claims. While post-petition legal malpractice claims must be brought within the applicable state statue of limitations, as a practical matter they should be brought prior to entry of an order on the attorney's final fee application. If an order is entered on the attorney's final fee application (even if the order is unfavorable to the attorney), the malpractice claim will likely be barred under the doctrine of *res judicata*.

Generally speaking, *res judicata* operates to bar litigation of a claim involving the same claim and the same parties as in prior litigation in which there has been a final judgment on the merits. As it pertains to the issue of claims for legal malpractice related to bankruptcy representation, several circuit courts have found that adjudication of a professional's final fee application during a bankruptcy proceeding can foreclose the possibility of that professional later being sued for malpractice. *Capitol Hill Group v. Pillsbury, Winthrop, Show, Pittman, LLC*, 569 F.3d 485, 490 (DC Cir. 2009).

In *Capitol Hill,* the debtor brought a malpractice claim against its former bankruptcy counsel, alleging that the attorneys failed to notify them about the issuance of a zoning adjustment order adverse to debtor's interests and that the attorneys had mishandled the representation of debtors with regards to that zoning adjustment. Prior to the filing of the claim, the debtors and the attorneys participated in multiple contested bankruptcy hearings and a trial regarding the attorneys' final fee application. After finding that the debtor had either actual or constructive knowledge of its claims against its attorneys, the court affirmed the dismissal of the debtor's malpractice claim on the basis of *res judicata*. *Id*. at 335.

The same result ensued in *Grausz*, 321 F.3d 467. In *Grausz*, the Fourth Circuit rejected the debtor's argument that he was not a "party" to the previous fee application because by the time of the fee application he was no longer the debtor-in-possession, having been replaced by an appointed trustee. The debtor argued that he therefore no longer had any interest in the outcome of the fee application. The court disagreed, finding "[i]f legal fees were reduced or disallowed, there would be more money available in the estate to pay the nondischargeable priority claims, and Grausz's personal liability would be reduced. Grausz therefore had a pecuniary interest in the outcome of the fee applications, making him a party in interest to the proceeding." *Id*. at 473.

The court in *Grausz* also explained rather cogently how the "core of operative facts" were the same in both the fee application proceeding and the malpractice action. The court held that "[b]oth actions relate to the nature and quality of legal services the [attorney] provided to Grausz in connection with the bankruptcy proceeding." *Id*. at 473. And the court also held that "[t]he fee application proceeding necessarily included an inquiry by the bankruptcy court into the quality of professional services rendered by the [attorney]" and in granting the final fee application, "the bankruptcy court impliedly found that the firm's services were acceptable throughout its representation of Grausz." *Id*.

Finally, the court in *Grausz* rejected the debtor's argument that the fee application proceeding did not afford him an effective forum to litigate his malpractice claim because he would have been deprived of his right to a jury trial. The court held that Grausz should have objected to the fee application and asserted his counterclaim for malpractice, which would have then converted the contested matter to an adversary proceeding. The court then noted that there were three procedures in place for Grausz to get a jury trial, including withdrawal of the reference for the district court, if necessary.

The moral of the story is that if the debtor or any other party in interest believes it might have a malpractice claim against a bankruptcy attorney or other professional appointed in the bankruptcy proceeding, that claim must be asserted as an objection/counterclaim to the professional's final fee application, or the claim may be barred under the doctrine of *res judicata*.

## V. CONCLUSION

Obviously, all bankruptcy practitioners should continue to exercise great care in rendering legal services to their clients. If, however, you find yourself the object of a malpractice claim in the bankruptcy context, or if you find yourself advising a client who believes he has been the victim of legal malpractice in the bankruptcy context, asking the questions of "who, where, and when" should provide you with a useful start in analyzing the procedural complications of such claims.

# Lawyer Liability Issues in the Bankruptcy Practice

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ALAS insures over 200 major law firms against professional liability claims. Since we opened our doors in 1979, ALAS has handled over 400 claims involving the bankruptcy practice. The most significant drivers of those claims, in order of magnitude, include allegations of a significant error, conflicts of interest, and unworthy clients. This article discusses each of these factors.

## Negligence

Negligence in bankruptcy work has been a recurring source of our bankruptcy claims and has cost ALAS and its firms more money than any other factor. These claims are often the result of nonbankruptcy lawyers practicing bankruptcy law, bankruptcy lawyers committing litigation errors, business lawyers failing to understand the bankruptcy significance of certain transactions, or associates and paralegals working without adequate supervision. Common errors include the failure to timely file documents, failure to perfect security interests, and inappropriate advice on whether to pursue bankruptcy.

Our failure to file loss prevention advice is straightforward. First, docket deadlines at the *outset* of a representation, and update your calendar continuously as additional pleadings are filed. Second, on creditor engagements, promptly review the schedules, statement of financial affairs, and docket sheet to determine whether any relevant motions or orders require a response. Third, request service of documents, and review new filings for relevance to your client. Fourth, know the local rules on electronic filing, both with respect to what pleadings can be filed electronically, the filing cutoff time, and who is authorized to provide electronic signature. Fifth, confirm the scope of your responsibilities with the client in writing (*e.g.*, memorialize that the client will file its own proof of claim).

While failures to perfect a security interest are less frequent, the consequences can be serious in large corporate bankruptcies. Many mistakes in this area are made by associates or paralegals, so they need proper training and oversight. That means the responsible partner should personally review any UCC statements (including exhibits) before filing. When possible, use a single, uniform exhibit describing the collateral in the loan agreement, the security agreement, the UCC financing statement, and other related documents. Recognize the risk of relying on third-party vendors to file UCC statements and run searches, carefully review their work, and reject any liability disclaimers in their contracts. Conduct postclosing UCC searches to ensure that all filings have been properly made. Make a clear record with the client on who is responsible for filing continuation statements, and docket and calendar expirations dates if you take on this task.

We have also seen claims alleging negligent advice about whether to file a bankruptcy petition. The clients making these claims are either disappointed with the results of bankruptcy and claim they should have been discouraged from filing, or they do not like the results of the out-of-court approach, and claim bankruptcy would have been a panacea. Bankruptcy lawyers should try to avoid these claims by documenting their advice to clients on this issue early, and in as much detail as possible. Putting it in writing will avoid hindsight distortions of the advice and help demonstrate that the lawyer's recommendation was a reasonable judgment call.

## Conflicts of Interest

Conflict of interest issues are often a problem in bankruptcy claims. Normally, the conflict allegation is not the only, or even the primary, issue in the claim, but it greatly complicates the defense. These claims typically raise issues under state-specific versions of ABA Model Rule 1.7(a). Some involve debtor representations (where lack of disinterestedness and adequate disclosure may also be issues), some relate to relationships with others in the bankruptcy process (*e.g.,* secured creditors), and some involve multiple representations in the bankruptcy itself.

One common scenario involves a creditor's law firm, which has never represented the debtor, but has other clients with interests in the bankruptcy case, such as shareholders, property owners, tenants, partners, guarantors, trustees, insurers, or other estate professionals. If the interests of those parties could be adversely affected by the firm's representation of the creditor, the firm needs to address the possible conflict at the outset. If you fail to do so, and the representation turns out badly, a skillful plaintiff's lawyer could exploit the situation. This is particularly true if your bankruptcy representation is a one-shot engagement and the other client is a long-time client with substantial billings. We have seen several firms unfairly charged with conflicts in these situations, even though their substantive bankruptcy work has been, in our view, first rate.

Often, conflicts are properly identified but then resolved in less than textbook fashion. Sometimes, the lawyer made oral disclosure, and a dispute arose later (in the malpractice case) as to the contents and adequacy of the disclosure. Other times, the issue is whether the disclosure to the court should have been more extensive. These claims are not limited to allegedly inadequate disclosures about relationships with other parties in interest, but also include alleged misrepresentations about the firm's relationship with other professionals, or the firm's own fee arrangements. We have found the latter type of conflict, involving the firm's own economic interests, particularly dangerous.

The appropriate response to these claims is obvious. More care must be taken in recognizing and dealing with conflicts, particularly at the outset of the representation. In debtor representations full disclosure under the Bankruptcy Code and Rules is critical. In our experience, if full disclosure is made, bankruptcy judges will sometimes find disinterestedness where we might not. Be careful, however, because other judges (*e.g.*, in a later malpractice case) may not be so charitable. Moreover, when full disclosure is *not* made, federal judges may treat nondisclosing lawyers harshly. *See, e.g.*, *U.S. v. Gellene,* 245 F. Supp. 922 (E.D. Wis. 1998) (bankruptcy lawyer sentenced to 15 months in prison for false disclosure); *In Re Granite Partners, L.P.,* 219 B.R. 22 (Bankr. S.D.N.Y. 1998) ($3 million sanction imposed for inadequate disclosure).

The bottom line on conflicts in bankruptcy matters is that they are not defined solely by the Bankruptcy Code, but also by the applicable rules of professional conduct; that those rules may mandate disclosure, consent, or withdrawal even if the Bankruptcy Code does not; that consultation with the firm's general counsel or ethics committee on close conflicts issues is critical; and that when a conflict waiver is appropriate proper written disclosure and consent is required.

## Unworthy Clients

Unworthy bankruptcy clients are fairly infrequent, but representing one can lead to a claim that is expensive to defend and resolve. The term includes both dishonest clients and those who always blame others for their business failures.

Since bankruptcy clients—by definition—are involved in business failures, some bankruptcy lawyers assume that they must represent unworthy clients and that standard business intake client due diligence procedures do not apply. In fact, the opposite is true. Since an unworthy client claim in this area can be very severe, we believe bankruptcy lawyers need to pay special attention to client quality. Run an Internet search to create a portrait of the client, and its principals. Determine if the client has sued prior law firms. If the client is asking you to replace prior counsel midstream, ask to talk to the recently dismissed lawyer. These are simple steps that can indicate that the potential client is not worthy of your time.

Sometimes, however, your due diligence will not reveal the client's true colors. In those cases, be wary of clients that insist on making questionable transfers on the eve of—or in the midst of—insolvency. Failure to do so will often lead to a claim that the lawyer aided and abetted the client's fraudulent conveyance. Know the warning signs of a questionable transaction—such as a transfer between related entities without a solid and independent evaluation of value—if you want to avoid trouble here. Also, carefully confirm that the client has provided you with accurate and complete information on their assets. Ask your debtor client probing questions to elicit complete and accurate disclosure, and check readily available public records to confirm client statements. Otherwise, the sanctions motion resulting from an incomplete or otherwise questionable disclosure will likely name the lawyer as well as the client. Adding insult to injury, the client may well blame the lawyer for not making sure the required disclosures were correct.

Clients that second-guess everything you do, complain about every bill, and otherwise are never satisfied, are obviously trouble. In our experience, they typically blame the lawyer when the outcome of the bankruptcy case is less than perfect, often pointing to a tactical decision that made sense at the time but can be criticized later with the clarity of hindsight. In many of these situations, either the lawyer did not fully involve the client in the decision or she failed to document the discussion with the client and his endorsement of the strategy. Better communication with the client and better documentation of those communications are basic loss prevention solutions here.

## Conclusion

ALAS's bankruptcy claims reflect trends we see in most other practice areas. Negligence of various stripes leads the way, and better supervision, improved docketing, and enhanced documentation with the client can help avoid or at least mitigate these claims. Conflicts of interest can be a hornet's nest in the bankruptcy setting, and a clear understanding of how the applicable rules of professional conduct intersect with the Bankruptcy Code is essential to identifying and resolving conflict issues. Unworthy clients can be avoided by appropriate due diligence at intake, but if you find yourself representing a potentially dishonorable or impossible to satisfy client make sure to independently confirm their representations and make a written record of your advice.