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Defending Professional Liability Claims in Bankruptcy Court

By David C. Anderson

Strangers in a strange land. That's how many defense lawyers and claims examiners feel when defending an insured lawyer in bankruptcy court after the client has filed for bankruptcy. Bankruptcy trustees, creditors' committees and liquidating trusts make very dangerous plaintiffs. And many defense lawyers feel like they have been dragged into bankruptcy court ''separated from their wallets without any concern for proximate cause or liability issues.''

That was the sentiment of Johannes Kingma, a partner at Carlock, Copeland & Stair LLP in Atlanta, who moderated a panel discussion on defending legal malpractice claims in bankruptcy court.

Kingma was joined by Allison McCabe, a senior claims examiner at Aspen Insurance in New York, and Rob Charles, a bankruptcy lawyer and partner at Lewis Roca Rothgerber in Tucson, Ariz. Together, they revealed some of the inner workings of professional malpractice claims in bankruptcy court.

Square Deal in Bankruptcy Court?

Kingma queried whether a defendant lawyer could ever get a ''square deal'' in bankruptcy court given that it seems as though the deck is stacked against him because the trustees are interested in pursuing everyone in the neighborhood of a failed enterprise.

Charles explained that generally the bankruptcy process focuses mainly on economics, particularly when there is a trustee assigned. While notions of liability are not irrelevant, he said, they are less relevant, particularly in circumstances where there is little in the way of funds available to pay creditors' claims.

Panelists also discussed the ''strange anomaly'' in bankruptcy court where in many cases professionals charge $700 or $800 per hour until all the money is bled out of the bankruptcy estate and then they just close the case.

It is true that bankruptcy is expensive, Charles said. But with the decline in bankruptcy cases filed, he said, such aggressive billing is also on the decline. In the average case where the stakes are important, but there isn't sufficient money available to pay for the trustee or his counsel to ''bill like a drunken sailor,'' defense counsel may have a better opportunity to obtain a favorable result for her client, Charles said.

The panel agreed that defense lawyers can be successful in bankruptcy court if they have a sense of the players, understand that they are no longer in the trial court to which they've become accustomed and, as McCabe noted, they familiarize themselves with the bankruptcy rules so they can ''play in the bankruptcy club where everyone seems to know each other already.''

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Sanctions Against Bankruptcy Trustees

Kingma followed up by asking, with a degree of sarcasm, whether ''in the history of federal jurisprudence, a bankruptcy judge has ever assessed sanctions against a trustee'' for abusively pursuing claims.

Charles indicated that he had to do some research to discover that such sanctions have, in fact, been assessed in the past. But they are rare, he noted.

Just like persuading a federal district judge to award sanctions under Fed. R. Civ. P. 11 is an infrequent event, persuading a bankruptcy judge to award sanctions under Bankruptcy Rule 9011 is also an infrequent event, he said. ''You can demand them all you want, but they're hard to get,'' Charles told the audience.

The Right to a Jury Trial

Many defense lawyers like to have a jury, if necessary, ultimately decide the issues of a professional malpractice case because they know how to communicate to a jury. But to many defense lawyers, bankruptcy court seems to be set up to prevent a jury from deciding claims; instead, a bankruptcy judge, who may appear to rely a bit too much on the trustee, makes all of the decisions. Kingma grilled Charles as to how such a scenario can be constitutional.

Charles responded, ''The layers of misinformation in that question are mind boggling,'' causing the audience to chuckle. He then listed what he sees as those layers of misinformation:

- Very few of his partners who are defense lawyers say they want a state court jury going after their profession.

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■ A bankruptcy judge is like a magistrate. The judge may not conduct a jury trial absent consent.

■ ''Only an idiot would ask a bankruptcy judge to conduct a jury trial'' because that's not what she does. Managing juries takes skill, and bankruptcy judges just don't have that skill.

■ If you're in a bankruptcy-related case and you need a jury trial, you're going to ask the federal district judge to withdraw the reference and conduct a jury trial.

■ After the reference is withdrawn, the frustration will continue when you are sent back to the bankruptcy judge who will act like a pretrial magistrate and decide discovery issues.

McCabe said malpractice insurers do not have a standard policy regarding whether to proceed in bankruptcy court. Instead, she said, they consider each matter on a case-by-case basis and take defense counsel's recommendation into consideration.

2004 Examinations: Fishing Expedition?

Bankruptcy Rule 2004 essentially says that the court can authorize anyone to examine anyone about anything related to a debtor, assets, liabilities, the possibility of reorganization and so on.

In the context of a potential claim against a professional, that rule allows a trustee or his lawyer to essentially conduct pre-litigation discovery and presents an opportunity for a fishing expedition that can be frustrating for the professional, speakers said. Many times, no litigation is pending and no issues have been framed when the 2004 examination takes place.

McCabe said an insurance carrier often gets involved upon notice of a 2004 examination because it is usually the first sign of trouble. And the insurer will often get defense counsel involved at that point as well, she said.

Rule 2004 examinations are public unless a protective order is obtained. Charles pointed out, however, that if a debtor claims professional malpractice, the attorney-client privilege may be held by the trustee depending on whether the debtor is an entity or an individual. Therefore, he said, you may not have grounds to seek a protective order on that basis because the privilege may have been transferred to the trustee per U.S. Supreme Court precedent.

An Arrow for Defense Counsel's Quiver

Kingma advised that if you learn of a 2004 examination notice, review the bankruptcy schedules early. ''There's all sorts of good information in the bankruptcy schedules,'' he said.

Charles said that if a debtor fails to identify his professional malpractice claim as an asset in the bankruptcy schedules, the defendant professional will have a relatively strong defense based on judicial estoppel.

''The number of debtors who don't tell their bankruptcy lawyer or trustee about pending causes of action, not just professional liability, but ordinary personal injury, any number of causes of action, would stagger you,'' Charles stated.

On the other hand, he said, if the cause of action has, in fact, been listed in the schedules, defense counsel can learn a lot about the debtor's income, expenses, real estate values and what the trustee estimates the professional malpractice claim may be worth, which all aid in conducting a damage analysis.

341 Meetings

In every bankruptcy case there is an initial meeting of creditors, and that meeting is sometimes called a 341 meeting after the section of the Bankruptcy Code that authorizes it, 11 U.S.C. § 341.

At that public meeting, trustees and creditors ask questions of the debtor regarding the schedules and statements. It is typically short in duration, lasting no more than an hour and sometimes far less time.

Charles explained, ''It can be a place to get information. Not a great place unless you have one or two questions that need to be answered in order to file a dispositive motion. The typical bankruptcy lawyer doesn't prepare his client for a 341 meeting as he would a deposition.''

If you pursue that strategy, he said, you may want to bring a court reporter with you because a 341 meeting is recorded, but not normally transcribed.

Anyone can attend a 341 meeting, but it's unclear whether a noncreditor may ask questions, he said. Charles added, however, that there's a lot of flexibility because a judge does not preside over the 341 meeting and the pool of creditors is not clearly defined at the beginning of a bankruptcy.

Proofs of Claim for Fees

Lawyers who are owed fees by clients that go bankrupt often file proofs of claim in bankruptcy court. The only way to share in the distribution of assets in a Chapter 7 bankruptcy case is through the filing of a proof of claim. A proof of claim is unnecessary in a Chapter 11 bankruptcy case provided your claim is properly scheduled.

The panel considered whether it is wise for a lawyer to file a proof of claim for unpaid fees when a client files for bankruptcy. Charles indicated that the analysis is not unlike that undertaken when deciding whether to sue a client directly for unpaid fees. Counsel should assess the probability of being counter-sued for professional negligence and determine whether the risk outweighs the potential reward, he said.

Paying a Trustee or Trustee's Lawyer

Kingma asked how trustees and their lawyers are paid in bankruptcy court and how the way in which they are paid may impact settlement of claims.

Charles explained that trustees are paid reasonable compensation, which typically is based on some kind of hourly accounting but capped by a schedule based on assets distributed.

In a Chapter 7 case where there are no assets, he said, the trustee gets a fee of $100 to administer the case. That, he said, tells you the trustee who owns the debtor's claim for alleged professional liability is paid based upon a percentage of what he recovers. ''So, the trustee has an economic incentive to find money to pay creditors because without that the trustee does work but won't get paid for it,'' Charles said.

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Charles also explained that the lawyers in a Chapter 11 case representing the debtor or the trustee are paid upon court approval after a fee application is filed to the extent there are unencumbered assets available to pay claims, or they can be retained as special counsel.

The trustee can hire a lawyer on a contingent fee basis with court approval and then they are paid the way a plaintiff's lawyer is typically paid outside of the bankruptcy context, he said.

The panel agreed that it is often more beneficial to attempt to resolve a case with a trustee than it would be with the classic professional malpractice plaintiff. While the plaintiff may be angry or simply ''making it up,'' a trustee is solely economically motivated, they explained.

There isn't any magical time to approach the trustee regarding settlement, panelists said. However, in a Chapter 7 case, you probably want to do that shortly before the initial meeting of creditors because that is when the trustee will likely first pay attention to the matter. In a Chapter 11 case, defense counsel will need to find a way to get the trustee's attention over that of others who are also trying to get her attention regarding the issues they believe are important.

Bar Orders (Not the Alcoholic Kind)

Bar orders, after a period of time set by the court, preclude claims brought by those who are not the settling plaintiff, such as a trustee or debtor in possession.

The panel said such orders are useful to professional liability defendants that agree to settle claims brought by the trustee or debtor in possession but are concerned that similar claims might be brought by others.

A bar order allows a settling plaintiff to ''give defendant and the insurance company a release in a way that is much more comforting,'' Charles said, as it allows a defendant to settle without having to be concerned that others will bring similar claims.

Eroding Limits Policies

McCabe asked her fellow panelists about their experience with bankruptcy lawyers and trustees when the issue of eroding policy limits in the professional liability context arises—i.e., when defense costs eat away at the amount available for payment of claims.

Kingma said his experience has been that bankruptcy lawyers and trustees care less about eroding policy limits than do typical professional liability plaintiffs.

He said he often discusses the eroding limits issue with trustees early in the process in an effort to explain to them that an early agreement to settle is to their benefit. But many trustees are interested in learning about the defendant's personal assets and will often require a defendant to execute an affidavit attesting to his assets before any settlement can be reached, Kingma said.

''It really depends on the sophistication of the trustee and the trustee's counsel,'' Charles offered. Charles said that many times when he is representing a creditor in bankruptcy he will inquire of the trustee as to the insurance situation. ''So, there can be a lot of voices who speak to that topic,'' he stated.

Bankruptcy Court vs. State Court

Kingma segued into the next section of the discussion by asking Charles, ''If you were a defendant, would you rather be in bankruptcy court?''

Charles's response was ''It depends.''

It's a more difficult question to determine whether you'd prefer federal district court over bankruptcy court, he said. But if you are comparing bankruptcy court to state court, he continued, here are some things to consider:

- Many defense lawyers routinely remove cases from state court to federal court.
- Depending on your state, a unanimous verdict might only be required in federal court, and the jury venire process could be quite different.
- Your case, while in bankruptcy court, may be tried before the federal district court anyway.
- Bankruptcy judges may be less busy than state court judges and maybe you want a trial quickly.
- If you have a complex commercial case, a bankruptcy judge may be more adept at handling it.
- You may think the bankruptcy judge will be more helpful on pretrial issues.

Trustee Conflicts and the 'Multi-Party Mess'

Trustees must attest that they have no conflicts in connection with the bankruptcy matters they handle. ''The trustee and the trustee's lawyers should be disinterested,'' Charles said.

If a trustee fails to reveal a conflict that is subsequently discovered, he said, it may lead to the disgorgement of the trustee's fees. ''And it's a crime,'' Charles added. ''Everything that is done in a bankruptcy is filed under penalty of perjury and there is a criminal statute, 28 U.S.C. § 152, that makes a lot of things criminal that you might think were just stupid or negligent.''

Kingma said he has been able to strategically take advantage of the rule against conflicts in the past.

He explained that the bankruptcy bar is ''pretty small and when there's a big case, there's lots of phone calls flying around before bankruptcy is filed and then thereafter.'' Sometimes, bankruptcy trustees and lawyers will forget that they were part of the information ''swirling around,'' he said. And if you can document their involvement, ''that could give you a lot of leverage and that's something to think about,'' Kingma advised.

McCabe agreed and described her experience where a lawyer who represented a legal malpractice plaintiff was later disqualified from representing the trustee after the plaintiff filed for bankruptcy. Where the plaintiff-debtor and trustee's views on settlement diverge, a conflict is created that likely disqualifies the lawyer from continuing his representation, she said.

Creditor's Committee

A creditor's committee is made up of 20 of the largest unsecured creditors in a Chapter 11 reorganization. They are fiduciaries for all of the creditors, not just their individual interests, and the committee may retain counsel at the expense of the bankruptcy estate.

Kingma likened creditors' committees to the ''mob with pitch forks and torches circling the castle.'' Sometimes, he said, the creditors' committee will seek permission from the court to pursue claims, perhaps against a professional, if the debtor in possession

chooses to abandon it. If allowed, then a professional may have to defend against the committee, which acts much the same way a trustee would if appointed.

Liquidating Trusts

Liquidating trusts receive the rights and causes of action of the debtor post-Chapter 11 plan confirmation. So, a professional may find himself sued by a liquidating trust in bankruptcy court.

When defending such a claim, Charles advised ''doing your homework'' and reviewing the disclosure statement that is supposed to disclose assets.

''It's frightening how often causes of action are brought post-confirmation that were not disclosed in the disclosure statement,'' Charles told the audience. Just like when a debtor fails to identify a cause of action in her bankruptcy schedules, if a cause of action is not disclosed in the disclosure statement, judicial estoppel (or a similar concept) may apply to preclude the claim, he said.

In Pari Delicto—a Great Tool

While successful use of the in pari delicto (at equal fault) defense varies from jurisdiction to jurisdiction, the panel agreed that it can be a great tool in this context.

''The notion is, under state law or federal common law, that management is in pari delicto with the alleged tortious professional and the trustee can't pretend like management wasn't making those decisions,'' Charles explained.

The company acts through its management, it's bound by the decisions of management, and it can't then turn around and sue its lawyer for decisions it intentionally made, he said.

Kingma cautioned that factual issues may preclude the application of the in pari delicto defense, but he said defense lawyers would be wise to develop such a defense if possible.

Opportunity and Optimism

The panel summed up by encouraging defense counsel to be optimistic that the bankruptcy trustee will make a better adversary than the typical professional liability plaintiff.

They also said there's a lot more opportunity if defense counsel is informed about the bankruptcy process and perhaps consults with a bankruptcy lawyer along the way.

Even Kingma ultimately conceded that bankruptcy court is ''a good place to get cases resolved, one way or another.''

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