LEGAL MALPRACTICE IN BANKRUPTCY CASES

Prepared by:

Michael J. O'Connor
Law Office of Michael J. O'Connor
8118 Datapoint Drive
San Antonio, Texas 78229
(210) 614-6400
(210) 614-6401
oconnorlaw@gmail.com

Prepared for the San Antonio Bankruptcy Bar Association, August 22, 2017

Black Letter Texas Bankruptcy Law

Elements

To prevail on a legal malpractice claim, a plaintiff must show "that (1) the attorney owed the plaintiff a duty, (2) the attorney breached that duty, (3) the breach proximately caused the plaintiff's injuries, and (4) damages occurred." *Peeler v. Hughes & Luce*, 909 S.W.2d 494, 496, 38 Tex. Sup. Ct. J. 1117 (Tex. 1995)

Alexander v. Turtur & Assoc. 143 S.W.3d 113 (Tex. 2004)

In this case, Alexander was the lead counsel hired by the plaintiff, Turtur & Assoc. (family partnership) to sue a third party, McKellar. The litigation began in state court as cross claims for breach of contract, fraud, breach of fiduciary duty etc. Turtur became a plaintiff in an adversary proceeding after McKellar filed bankruptcy and Turtur filed a proof of claim. The claims against McKellar were predominately state court claims. Alexander could not try the case and his associate, who was inexperienced tried the adversary proceeding and lost.The bankruptcy court held in favor of McKellar the debtor in the amount of $105,718.80. Turtur sued Alexander in state court and awarded $3.0 million in damages against Alexander. The court of appeals upheld the verdict stating that there was proof that Alexander's choice to allow the associate to try the case and proof that the associate did not introduce evidence at the adversary proceeding was sufficient proof of causation. The Supreme Court disagreed and reversed based on the lack of expert testimony as to the causation element of Turtur's claim. Peterson, the Turtur's expert witness testimony was analyzed by the Supreme Court as follows:

All we glean from it is that Peterson believed the bankruptcy judge decided the case on the evidence before him, praiseworthy in a judge but hardly probative on the issue of attorney malpractice. Moreover, the court of appeals failed to quote a second sentence in which Peterson disclaimed knowledge of any other evidence that might have changed the judge's decision. Peterson's full response to the question was:

> I can comment that, in my opinion, the evidence that was offered and admitted at trial caused Judge Able to make the decision that he made. *I can't tell you what other evidence might have been out there that might have resulted in a different decision.* 143 S.W.3d at 122 (*emphasis added*.

Sidenote:

"I agree with the Court that without expert testimony, which it did not have, the jury in this legal malpractice case could not possibly have made a reasoned determination that U.S. Bankruptcy Judge Houston Abel would have decided fact issues in a 1987 adversary proceeding differently if only Tom Alexander had represented the creditor instead of Judy Mingledorff, or if Mingledorff had presented different evidence. *But I also doubt whether a jury could ever be fairly expected to determine, even with expert testimony, what a judge would have decided in such hypothetical circumstances, and if a jury is to be assigned that responsibility, I worry what the testimony would be.* The only person who might actually know what a trial judge would have done if a case had been presented differently is the judge himself, if his memory would serve, but he probably cannot testify voluntarily and should not be compelled. *Alexander v. Turtur & Assoc.* 146 S.W.3d 113, 123 (Tex. 2004 concurrence by Justice Hecht *emphasis added*)."

Bankruptcy Cases

Is a claim property of the estate?

Burgess v. Sikes, 438 F.3d 493 (5th Cir. 2006)

If it's pre-petition what does it take to drag it into the estate?

This case addresses the extensive scope of 11 USC §541 on prepetition contingent claims. It involves a crop disaster relief payment to which debtor became entitled after the case was filed. The Chapter 7 was filed in August 2002 and discharged in December 2002. In February 2003 Agricultural Assistance Act was enacted to compensate for crop losses in 2001 and 2002. Debtor got a check for $24,829, Chapter 7 trustee reopened and filed for turnover.

Ruling:

§541 clearly states that a bankruptcy estate is established at "the commencement of [the] case." Thus, Burgess had no interest, contingent or otherwise, in the disaster-relief payment when he filed his bankruptcy petition. 438 F.3d at 504.

Does this mean an undiscovered/unmatured prepetition claim for acts which took place prior to the Chapter 7 filing (by existing bankruptcy or previous state court counsel) is property of the estate?

Ethical quandary: Is there a duty to "report on yourself" i.e. list the debtor's claim (albeit contingent) on the schedules? Do you treat it as something that does not exist?

Who owns the claim?

Ostrander v. Van Dam (In re Mateer) 559 B.R. 1 (Bankr. D. Mass. 2016)

This is a timing of cause of action/who owns the claim case. Ostrander the Trustee sued Van Dam the lawyer in a post-petition adversary proceeding. The trustee sued Van Dam because Van Dam (before the bankruptcy Chapter 13 case was filed) failed to file a Massachusetts state law real property document and in doing so caused Mateer the Debtor to have a $125,000 homestead exemption instead of a

$500,000 homestead exemption. This shortfall apparently caused the Ostrander the Trustee to obtain a post-petition judgment for $34,502.46 against Mateer. Ostrander also sued Van Dam for converting his 13 to a 7 because Mateer could have received a discharge had he dismissed and refiled a 13. Trustee predicated standing on the fact that the failure to file the $500k homestead claim was a prepetition act which made the claim "sufficiently rooted in the prebankruptcy past" to make all of the claims in his lawsuit property of the estate. Court held for Van Dam because the because the causation and damages elements of the malpractice tort claim did not accrue until after the filing.

Indictment as Date of Accrual

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

Wheeler filed Chapter 7 and Magdovitz was his lawyer in 1989. Wheeler signed the documents which stated there were no assets and the case was closed as a no asset case. Wheeler received his discharge. Five years later, Wheeler was indicted and convicted for falsifying and concealing assets which should have been included in the estate. Then, Wheeler sued Magdovitz claiming that as being a personal of little formal education he relied on Magdovitz, that Magdovitz was negligent and caused his conviction. The bankruptcy court held that Wheeler's claim belonged to the bankruptcy estate and was subject to administration by the trustee, not Wheeler, who argued he had no claim until he was convicted in 1994, five years after he lied on his schedules. The 5th Circuit agreed Wheeler did not own the claim and followed other cases which hold that the cause of action was a prepetition claim and did not accrue at indictment because his claims against Magdovitz were based on negligence in performing prepetition services and providing prepetition advice.

"A debtor need not be aware of the full extent of his harm for his claim to accrue, since it is sufficient that he knew, or should have known, that any false statements and concealments in his bankruptcy filing were transgressions which could bring about serious consequences." 137 F.3d at 301.

Self-preservation and disgorgement

Chandler v. McIntosh (In re McIntosh), 2015 Lexis 3760 9th Cir. BAP 2015.

Debtor owned real estate with three liens. The third lien was for funds owed state court counsel for representation in a will contest. Chandler the lawyer filed a 13 and stated he received $3500 and was owed $3000 in fees. He cut a deal with state court counsel for $10,000 of their third deed of trust lien and asserted (in his own interest) that their lien was not avoidable under CA law when that issue arose in conjunction with a motion to sell property.

Then he wrote this:

"Following confirmation and after conducting legal research in the months of June and July 2014, I reached the conclusion that the Court was correct and that preservation of the avoided [state court lawyers'] lien for the estate occurred automatically. However, in so concluding, I was mindful that my office's interest in the case had become adverse to that of the Debtor on the issue of disposition of sale proceeds."

The debtor opposed his fee application for $75,670.82. The bankruptcy court denied the fee application and ordered disgorgement of the $10,000 based on conflict of interest.

Defense fees are recoverable

Frazin v. Haynes & Boone, LLP (In re Frazin) 413 B.R. 378 (Bankr. N.D. Tex. 2009)

H&B received court permission to be hired as debtor's counsel and successfully represented a bankruptcy debtor in state court in a prepetition pending lawsuit. H&B filed a fee application. In return, the debtor (who was a professional Beanie Baby salesperson) filed an adversary proceeding for legal malpractice against H&B alleging negligence, DTPA violations and breach of fiduciary duty. Court denied relief against Mr. Frazin and allowed H&B to recover the fees it incurred in defending the adversary proceeding.

When a Trustee who sues for malpractice on behalf of debtor

In re Anderson, 2010 Lexis 1648 (Bankr. W.D. Wis. 2010)

A builder had a construction lien against the debtor's house arising from a pre-petition state court lawsuit. Builder/creditor claimed that the Chapter 13 case should be converted to Chapter 7 arguing a Chapter 7 trustee would sue the state court lawyer who told them to move into the house even though they had not paid for it in full and some or all of the proceeds from that suit would go to the builder. Builder also objected to confirmation based on the best interest test under §1325(a)(4). The builder lost; the Chapter 13 plan was confirmed. The court found that the underlying claim against the state court lawyer was not shown to have any potential value.

Debtors who are not motivated to sue

Kaelin v. Bassett (In re Kaelin) 308 F.3d 885 (8th Cir. 2002).

The fact that the Debtors are not eager to pursue a claim against their former attorney and engage in even more litigation is not proof of their lack of good faith.

Arguably a debtor with a trustee-originated malpractice action arising from state court representation may have no obligation to pursue that claim. A claim arose post-petition against the debtor's state court counsel. In this case the debtor amended his exemptions and claimed the malpractice action as exempt. The trustee and creditors appealed. The 8th Circuit did not find the Debtor's posture to evidence bad faith. The Court stated: "Kaelin also indicated he was tired of the litigation process and had no desire to pursue such a claim. The mere fact that Kaelin wants to end his participation in litigation does not evidence his bad faith".

Disclosure of claims

In re Watts, 2012 Lexis 3694 (Bankr. S.D. Tex. 2012)

The debtor filed Chapter 7, got a new lawyer and converted to Chapter 13. The plan was confirmed. Then they sue their Chapter 7 lawyer in state court for not being a Chapter 13 lawyer, for causing them to fill in their schedules incorrectly, for advising them to convert to 13 so they wouldn't be charged with perjury, etc.

Debtor is a consumer lawyer, BTW. Debtor files suit in state court but doesn't disclose it. Claim was property of the Chapter 13 estate. Chapter 13 case dismissed for bad faith based on failure to disclose.

Sidenote; This case contains a good discussion of inadvertent nondisclosure of claims which is also germane for purposes of advising clients to disclose everything. The two leading 5th Circuit cases on this are: *Love v. Tyson Foods, Inc.* 677 F.3d 258 (5th Cir. 2012) (to prove "no motive to conceal" debtor must show absence of potential financial benefit). It also cites *In re Coastal Plains,* 179 F.3d 197 (5th Cir. 1999) holding the debtor is judicially estopped from pursuing an undisclosed claim.

Preserving Claims in a Plan

Nat'l Benevolent Ass'n of the Christian Church v. Weil, Gotshal & Manges, LLP (In re Nat'l Benevolent Ass'n of the Christian Church), 333 Fed. Appx. 822, 823, 2009 U.S. App. LEXIS 12614, *1, 51 Bankr. Ct. Dec. 199 (5th Cir. Tex. June 11, 2009)

In this case the malpractice claim was based on alleged pre-petition malpractice unrelated to services during the bankruptcy and the bankruptcy court's fee award. The law firm argued 11 U.S.C.S. § 1123(b) required dismissal of the claims for lack of subject-matter jurisdiction unless the confirmed plan specifically and unequivocally reserved them. It did not.

The plan's reservations of claims generally referred to the Professionals' actions during bankruptcy and/or in relation to a Professional's fee application. It defined "Professionals" as on employed in the Bankruptcy Cases under 11 U.S.C.S. §§ 327, 1103. It was reasonable to read the provisions as reserving only claims as to post-petition conduct because the firm only became a professional employed "in the Bankruptcy Case under §§ 327, 1103" after the bankruptcy was filed and after their employment was approved by the bankruptcy court.

The plan reserved claims against "Professionals" as to bankruptcy services and not claims against "professionals" generally. Thus, the reorganized debtor had no

standing to pursue those claims in federal court. The district court's judgment was vacated and the case dismissed for lack of jurisdiction.

Standing if your claim isn't reserved in a confirmed plan

Rossco Holdings, Inc. v. McConnell, 613 Fed. Appx. 302 (5th Cir. 2015)

Re-vesting "all property of the estate" or preserving the claims using terms like "Chapter 5 claims" or "any and all claims" is not enough to preserve a reorganized debtor's standing to sue professionals for malpractice allegedly committed during the Chapter 11 case. Once a 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.

Be careful how you settle.

Selenberg v. Bates (In re Selenberg), 856 F.3d 393 (5th Cir. 2017)

Bates was hurt in an accident and hired Selenberg to represent her. He didn't file suit in time and her claim was rendered valueless. He then offered to settle the potential (more like probable) malpractice claim against him by signing a note for $275,000 payable to her and further extending the prescriptive period (a Louisiana term for statute of limitations) for her to sue him for malpractice in the event he did not pay. He didn't pay, she sued, and he filed Chapter 7 so she sued him under 523(a)(2)(A). The Fifth Circuit affirmed a nondischargeable fraud judgment against him largely because he settled the case with her by executing the note without advising her to obtain independent counsel and by executing the note "bought himself two years" to avoid being sued.

Jurisdiction

Tanamor v. Chang Law Group, LLC (In re Tanamor), 2013 Bankr. Lexis 3076 (Bankr. D. Md. 2013).

Jurisdiction case involving the issue of "arising under" jurisdiction over a legal malpractice claim against a debtor's former bankruptcy counsel for negligent advice. Bad conduct: met with paralegal, never met with a lawyer, no one explained the documents she was signing, no credit counseling completed

prepetition (two days post-petition), petition and schedules "riddled with errors and misrepresentations". The first Chapter 7 case gets dismissed. But Ms. Tanamor is not informed of this. Chang then files a second Chapter 7 on behalf of Ms. Tanamor with the same schedules. Tanamor did not sign the petition or schedules in Case #2. Somehow Tanamor got discharged in Chapter 7 #2.

Chang then files Chapter 13 seeking to avoid a second lien on Tanamor's homestead without telling her that the lien could not be avoided because Tanamor shared ownership with a third (non-bankruptcy) party. The 13 was dismissed because Chang failed to get a re-set of the creditors' meeting knowing Tanamor would not be available. Chang again did not inform Tanamor that Ch 13 (now the third case) had been dismissed. Chang filed another 13. Eventually Chang is suspended by the state bar and a new attorney takes over for Tanamor

Jurisdiction

Southmark Corp. v. Coopers & Lybrand (In re Southmark), 163 F.3d 925 (5th Cir. 1999)

Southmark was a REIT that got involved in issuing junk bonds through Drexel. It files Chapter 11, an examiner is appointed and the examiner's accountant gets sued in state court for not discovering that Drexel's junk bond investments (Michael Milken -- remember him) were so bad. The accountant removes the case. Discussions of mandatory and statutory abstention are addressed. Sort of a dated discussion in that it discusses bankruptcy jurisdiction in the context of *Marathon Oil* which long predates *Stern* and *Wellness.* Southmark obviously wanted the case to be tried in state court – the accountant obviously did not. The court held that there was a jurisdictional link to bankruptcy court because the fees paid to the accountant were professional administrative fees. In effect held that the malpractice claim was a core proceeding.

Arbitration Clauses

Royston, Rayzor, Vickery & Williams, LLP v. Lopez 467 S.W.3d 494 (Tex. 2015)

Lopez sued RRV&W for malpractice in connection with his divorce from his common law wife who had won $11 million in the lottery. Their engagement letter included this language:

> While we would hope that no dispute would ever arise out of our representation or this Employment Contract, you and the firm agree that any disputes arising out of or connected with this agreement (including, but not limited to the services performed by any attorney under this agreement) shall be submitted to binding arbitration in Nueces County, Texas, in accordance with appropriate statutes of the State of Texas and the Commercial Arbitration Rules of the American Arbitration Association (except, however, that this does not apply to any claims made by the firm for the recovery of its fees and expenses).

The state court denied RRV&W's motion to arbitrate and it filed an interlocutory appeal. The court of appeals affirmed stating that the clause was unconscionable. The Texas Supreme Court held that the clause was neither procedurally nor substantively unconscionable and that the arbitration clause was not one-sided even though claims for recovery of fees was excluded. The court also held that a Professional Ethics Committee report which required counsel to inform the client of the advantages and disadvantages of arbitration was not substantive Texas law and that parties are deemed to know and understand the contents of an attorney client contract just as in any other contract.