

AMERICAN BANKRUPTCY INSTITUTE

**18TH ANNUAL SOUTHWEST
BANKRUPTCY CONFERENCE**

**FOUR SEASONS RESORT
LAS VEGAS, NEVADA**

September 23 – 25, 2010

**POTENTIAL MALPRACTICE PITFALLS IN
BANKRUPTCY**

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POTENTIAL MALPRACTICE PITFALLS IN BANKRUPTCY

This outline is intended to provide the reader with a general overview of potential mine fields which need to be maneuvered in representing a bankruptcy debtor. It is designed to assist a lawyer in avoiding both common and unusual bankruptcy mistakes.

A. INITIAL CONFERENCE MISTAKES

You need to be on the alert from the very beginning in representing a bankruptcy debtor, starting with the very first contact you have with that individual or business. The following is an itemization of concerns you should have from the inception of the relationship.

1. Institute a screening system – before the client gets in the door, make sure you
really want the person as your client. I actually have two staff members who screen potential clients before an appointment is scheduled. My staff is trained to ascertain from the potential client his concerns and expectations, and if they are not realistic, an initial consultation is not scheduled. My assistants are especially sensitive to potential clients who already have representation and are seeking to change attorneys, though my staff is also familiar with which lawyers seem to have problems retaining clients. Potential clients are also warned about probable fees before they arrive since we do not want individuals to attend initial consultations just to discover that they cannot afford our rates.

2. Run a comprehensive conflict search – no one should be allowed to meet with you until a comprehensive conflict search has been completed. Because conducting a complete

conflict search is time intensive, my assistants are trained to screen potential clients and another reason why we charge for our initial consultations.

3. Recognize potential conflicts when meeting with clients – if a husband and wife appear to not be in accord, explain to them that your ability to represent both is conditioned upon them agreeing with the strategy you are outlining. In certain cases, if the relationship is strained, you would want them to seek independent counsel to approve the joint representation. When two or three co-owners of a business appear at your office, you need to alert the individuals as to whom or what you will be representing. If they want you to represent a business, you need to explain to them that you may not be able to represent them individually or, if they prefer you represent them individually, that they are aware of the potential conflicts. Oftentimes the conflicts are reconcilable, but only if there is full disclosure from the onset. Finally, recognize situations in which even though a new client may not have a current conflict with an existing client, a conflict may arise.

4. The supervising lawyer should meet with the client at the initial consultation – if you are in a high volume practice, this can be difficult to do, but you need to have a supervising or responsible lawyer meet with every potential client. The client deserves to meet with his lawyer, but more importantly, the lawyer needs to know whom he'll be representing. Over the years, I have refused to accept certain clients after talking to that person at the initial consultation.

5. You need to provide the statutory disclosures – the Reform Act specifically provides that unless your client receives the statutory disclosures, your right to be paid can be challenged. I make every client sign a copy of the disclosures for my file just in case we are ever audited. I fully understand that a lot of the verbiage in the disclosures borders on the nonsensical, but Congress, in its infinite wisdom, enacted this requirement and you should abide by it.

6. Consider non-bankruptcy alternatives – you need to have a working knowledge of other areas of the law including foreclosure and joint and several liability, because in many cases bankruptcy is not necessary. If your client owns non-recourse real estate, there may not be a reason to put him into bankruptcy. Especially when third parties may be involved or responsible, alternatives short of bankruptcy may be available. When a distraught ex-wife appears in your office and is contemplating bankruptcy because her ex-husband has now filed for bankruptcy and has left her with debts for which he has specifically indemnified her, she may be able to avoid bankruptcy by enforcing those rights under 11 U.S.C. § 523 (a)(15).

7. Meet both the husband and wife – many years ago I was retained by a woman who unfortunately proved to be a pathological liar. She managed to deny me access to her husband with a variety of believable excuses, but fortunately I was able to track him down. You can well imagine his surprise, disappointment and anger when he was advised that his family was 18 months behind on mortgage payments, was facing foreclosure, and had been in chapter 13 for six months. I was able to avoid embarrassment since I had not originally filed the case,

but I learned my lesson. Make it mandatory that prior to the bankruptcy filing a responsible person from your office has direct contact with both spouses.

8. Define the scope of initial consultation – every client who meets with anyone at my firm receives an e-mail confirmation limiting the scope of the representation to the initial consultation. This could be invaluable when a potential client starts telling creditors that you represent him after the initial consultation without retaining you. It also eliminates potential conflicts if, at a later date, you are retained by an adverse party on an un-related matter.

9. Consider all timing issues – ask questions about pending foreclosure dates and answer deadlines and other statutory periods. The client needs to understand unequivocally that until you are retained, he remains at risk. However, unless you have some idea as to the pending deadlines, it's difficult to advise clients as to the urgency of the situation.

10. Bring up tax implications at the initial conference – I always tell clients I am not a tax attorney nor am I qualified to render advice in that regard and I make it a practice to always warn clients that they need to speak to a tax expert in deciding whether or not to proceed. Many potential clients will tell me how they have been able to work out very good settlements on a large amount of debt, but do not realize that they may be facing devastating 1099s and non-dischargeable ordinary income taxes triggered by debt forgiveness.

B. COMMON MISTAKES ONCE RETAINED

1. Have a written fee agreement – make sure your client signs a written fee agreement. It should be in layman’s terms and break down what may be covered by a fixed fee and how much is charged for work beyond the initial scope of the agreement.

2. Use a CYA letter – if you are handling primarily simple and routine bankruptcies, the CYA letter may be relatively short and consist of primarily boilerplate. Nevertheless, use it. Even the simplest cases have many nuances, and relying purely upon forms can lead to major boondoggles.

3. Explain “property of the estate” – because of the potential ramifications of a client not understanding this concept, I provide the information to clients in three different forms. I give them a form which outlines their exemptions, each receives a boilerplate provision explaining discrete issues that may arise concerning property of the estate, and I then incorporate a discussion about the client’s specific situation. Even with all of this background, you need to be prepared to further clarify this issue.

4. Explain exemptions – every client receives my personalized discussion on exemptions, and then a specific overview of the client’s situation. Make sure your client is eligible to use Arizona exemptions. If he is not, then you need to be prepared to engage in a rather in-depth analysis about which state’s exemptions he can use, if any at all. If your client has sold his homestead before filing and is holding onto homestead proceedings, confirm your

client understands that he has 18 months to spend those homestead proceeds from the date of the house sale and that current case law suggests that the money must be earmarked for that purpose. You also want to make sure to claim the entire exemption amount, even if the asset is worth less, and finally, don't let your client transfer exempt property assets in advance of bankruptcy if such a transfer is fraudulent or preferential. If it is, case law provides that the assets will be returned to the bankruptcy estate and, in almost all cases, the debtor will not be able to claim the exemption.

5. Explain prebankruptcy planning – I now provide every client with a detailed explanation of prebankruptcy planning which requires over a page. I then speak about the client's specific situation and let the client decide how to proceed. I do not tell clients to engage in prebankruptcy planning; I simply explain to them the option and let them make the decision.

6. Explain eligibility – a client needs to understand that he may not be eligible for Chapter 7, and if he is not eligible, why he is not. At the same time, that client should be aware of reorganization options.

7. Explain the differences between Chapter 11 and 13 if eligibility is an issue – an in-depth discussion about the benefits of Chapter 11 over Chapter 13 is beyond the scope of this presentation, but it is something that should be considered if the client is not eligible for Chapter 7.

8. Explain setoff rights – it may be weeks, if not months, before your client actually files for bankruptcy protection. Your client will be very disappointed if his bank seizes his money because you did not warn the client about statutory and contractual setoff rights.

9. Explain the dischargeability concept – your client may not have one challenge mounted to any specific debt, but your client needs to understand this concept.

10. Explain the discharge concept – once again, your client may not have any discharge issues, but he needs to be aware of what this means.

11. Explain the reaffirmation process – before filing, your client needs to understand his options under the law.

12. Explain issues with surrendered real estate not foreclosed upon – until a foreclosure is completed by a lender, your client retains title to real estate in his name. He could easily get stuck with excessive homeowner association assessments, or even worse, be facing a postbankruptcy liability claim.

13. Confirm how your client owns assets – if your client wants to advance exemption rights, you need to make sure that the asset is owned by the debtor. With the exception of the homestead exemption, which can be asserted on a home titled in a living trust, assets titled to an L.L.C. or corporation cannot be exempted by the debtor.

14. Explain preferences – since oftentimes bankruptcies may not be filed for many months, if your client wants to avoid the reversal of a payment, he needs to understand the concept of preferences. Furthermore, you do not want your client to engage in excessive preferential transfers before bankruptcy because your client may be depleting funds he could devote to other purposes and, in certain instances, could lead to a discharge challenge.

15. Explain fraudulent transfers – all too often, a debtor has no idea that transfers to children that may have been appropriate under the gift tax laws are impermissible transfers. Your client needs to understand this concept so he does not continue this practice as bankruptcy nears and understands what may happen as to transfers that have already occurred.

16. Explain the Trustee's role in the process.

17. Explain the difference between a case closing and a discharge.

C. **MISTAKES TO AVOID ONCE A CASE IS FILED**

1. Prepare your client for the first meeting of creditors – the first meeting of creditors may be the first time your client has ever appeared at a legal proceeding. As importantly, since the Trustee may ask your client some unexpected questions, or a creditor may appear, ensure your client knows what to expect and understands why he is there.

2. Amend the schedules promptly – if an asset or obligation was missed in the initial schedules, take the extra time to ensure that the schedules are amended promptly.

3. Seek abandonment of encumbered real or personal property your client wants to keep – even today, attorneys do not understand that an increase in the value of an asset prior to abandonment belongs to the bankruptcy estate. To minimize the chances that your client may have to turn over an asset because of appreciation during the administration of a case, procure an abandonment order early in the proceeding. In 2004 through 2006, many debtors lost their homes because their attorneys disregarded this rule.

4. Timely reaffirm secured debts – current 9th circuit case law provides that, unless the debtor at least tries to reaffirm a secured personal property debt, the creditor has the absolute right to repossess the collateral even if the loan is current.

5. Do not have your client reaffirm debts unnecessarily – if not statutorily mandated, don't have your client reaffirm a secured debt. If he does and defaults, the creditor will have full recourse against the debtor as though the bankruptcy had never been filed.

D. RED FLAGS IN CHAPTER 11 AND 13

1. Assume commercial real estate leases within 120 days or obtain an extension to assume – if your client fails to timely assume such a lease and the lease is then rejected, the landlord can require your client to surrender the premises even if current.

2. Understand the absolute priority rule in Chapter 11s – your client will not be entitled to retain his equity position in a non-personal Chapter 11 unless all creditors are paid in full, new value is contributed into the plan, or creditors consent to a disruption of the absolute priority rule.*

3. Procure approval of impaired class in Chapter 11s – in all Chapter 11s, unless you procure approval of an impaired class, the plan cannot be confirmed without the consent of all creditors.

4. Understand when payments begin – in a Chapter 13, the first payments begin thirty (30) days from the filing of a case, whereas in a Chapter 11, payments do not begin in most cases until confirmation of the plan.

5. Be fluent with the new Supreme Court decision on calculating plan payments in a Chapter 13 – the *Jan Hamilton, Chapter 13 Trustee, Petitioner v. Stephanie Kay Lanning* decision from a little over a week ago ruled that plan payments are based upon anticipated or projected monthly income, not by considering disposable income for the six months prior to the bankruptcy filing.

6. Remember the plan must almost always be at least five years long.

* Not needed in personal Chapter 11s.

7. Warn your clients about the impact of additional income during the course of a plan – in Chapter 13s, it is supposed to be contributed into the plan, though the same may not be true in Chapter 11s.

8. Outline for your clients which expenses are authorized – you do not want your clients to be surprised to discover that certain expenses they have been paying their whole lives cannot be paid in a reorganization case.

9. Alert clients about potential dischargeability issues.

10. Explain the fee application process in a Chapter 11 or 13, unless the fees in a Chapter 13 fall under the cap amount.

11. Give your client a breakdown between transactions that are ordinary and do not require court approval and those that do.

12. Alert clients of the need to procure court approval of most professionals.

13. Explain to them the restrictions on paying professionals.

14. Warn them about the strict guidelines in a single asset real estate case.

This overview is not intended to be all exhaustive or to suggest that other problems may not arise in a bankruptcy case. Nonetheless, if you consider the matters covered in this presentation, you will have substantially reduced the chances that your case goes awry.