

# ARBITRATION ADVISORY

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## HANDLING A REQUEST FOR ARBITRATION WHEN A PARTY FILES FOR BANKRUPTCY

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### INTRODUCTION

In recent years there has been a significant increase in the number of bankruptcy filings. It is thus not surprising that arbitrators and administrators are more often required to deal with the impact of a bankruptcy filing on a pending fee arbitration proceeding. This Advisory will discuss some of the issues arising out of bankruptcy and offer suggestions for their handling in fee arbitration proceedings.

### RECOMMENDATIONS

Unless it is clear that going forward with the arbitration will not violate the automatic stay, the arbitration should be put in abeyance until an order for relief from the automatic stay or other appropriate order is obtained from the bankruptcy court.

In any bankruptcy filed under Chapter 7, or chapter 11 if a trustee has been appointed, the arbitration should not proceed unless the debtor<sup>1</sup> can establish that the debtor, and not the trustee, has the right to the property (i.e. the benefit sought by fee arbitration).

In a bankruptcy filed under Chapter 11 if no trustee has been appointed, (12 or 13), once it has been determined that the automatic stay does not apply, the arbitration may proceed with no further orders from the bankruptcy court.

### DISCUSSION

#### 1. Effect of Automatic Stay Provisions

##### A. What is the Automatic Stay?

Bankruptcy Code section 362(a)(1) provides that the filing of any bankruptcy

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<sup>1</sup>“Debtor” is the Bankruptcy Code description of the person who has commenced the bankruptcy proceeding.

case, regardless of the chapter, operates as a stay of:

"the commencement or continuation..... of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced against the debtor.....or to recover a claim against the debtor that arose before the commencement of the [bankruptcy proceeding]....."

This stay is automatic and is effective upon the filing of the bankruptcy. While the debtor need do nothing further to obtain the stay, if it has been determined that the stay applies, the other parties to the arbitration must take appropriate action to obtain relief from the stay before the arbitration can proceed [In re Gurga 176 B.R. 196 (9th Cir. BAP 1994)].

### **B. What are the Consequences of Violating the Automatic Stay?**

The consequences of violating the automatic stay can be significant. Those deemed by the bankruptcy court to have willfully violated the stay are subject to penalties for contempt, including, where appropriate, damages suffered by the debtor. [Bankruptcy Code section 362(k)]. Notwithstanding the statutory immunity provided by Business and Professions Code section 6200(f), there is no immunity under the bankruptcy code for either arbitrators or administrators who violate the automatic stay. Thus, it behooves all who receive notification of a possible bankruptcy by a party to cease all further activity in the fee arbitration proceeding until it can be determined:

- (1) that the party purportedly filing a bankruptcy proceeding has not, in fact, filed a bankruptcy proceeding; and
- (2) if the bankruptcy has been filed, the impact the automatic stay has upon the pending fee arbitration proceeding.

Generally, the debtor should submit evidence that the bankruptcy has been filed. At a minimum, the debtor should be able to provide the administrator or arbitrator with a case number, date of filing, and, in most cases, a conformed copy of the first page of the petition. If nothing is received to verify the bankruptcy, it is generally safe to proceed with the fee arbitration, particularly if the program notifies the debtor, in writing, of the intent to proceed if documentation is not provided, as well as its willingness to honor the automatic stay once the documentation is received.

### **C. When Does the Automatic Stay Preclude Further Proceedings?**

Once evidence is received that bankruptcy has been filed, it then becomes necessary to decide if the automatic stay precludes the fee arbitration from proceeding further. Although the automatic stay provision is broadly worded, it is not all encompassing. It applies only to matters which seek payment of fees and/or costs from the debtor. It does not generally apply where the debtor only seeks relief against another party. The following are examples of how the automatic stay provision would apply to specific fee arbitration proceedings in which a request for arbitration is made by the client:

- (1) Client is disputing the amount owed to the attorney but is not requesting a refund. Client files for bankruptcy. Because the client/debtor is attempting to prevent the attorney from collecting money from the client/debtor, the automatic stay would preclude the arbitration from proceeding further.

(2) Client is disputing the amount owed to the attorney but is not requesting a refund. The attorney files for bankruptcy. Because the client is not seeking a refund from the attorney, the automatic stay generally will not prevent the fee arbitration from proceeding.

(3) Client is seeking a refund of fees paid to attorney. Attorney is not seeking any additional fees. Client files for bankruptcy. The automatic stay would generally not apply because arbitration will not result in payment from client/debtor to attorney.

(4) Client is seeking a refund of fees paid to attorney. Attorney is not seeking any additional fees. Attorney files for bankruptcy. The automatic stay applies because attorney is being asked to refund money to client.

Keep in mind, however, that not all fee arbitration requests may be as clear as these examples. For instance, although a request for arbitration may appear on its face to involve a refund only, the request and any subsequent documents should be carefully reviewed to ensure that the attorney is not, in fact, asking for additional fees. If after reviewing the individual facts of the fee arbitration, the determination is made that the automatic stay does apply, the party who did not file bankruptcy must obtain permission from the bankruptcy court before the arbitration may continue, generally through an order granting relief from the stay

There are some instances where at first glance it seems clear that the only relief sought by the debtor in fee arbitration is the payment of money to the debtor, and that automatic stay, would, therefore, not apply. Questions as to the applicability of the automatic stay can still arise, however. This would occur when the non-debtor/party wishes to deduct a debt incurred before the filing of the bankruptcy from the claim for money made by the debtor/party [Bankruptcy Code section 362(a)(7)]. For example, the client retained the attorney to handle several matters and has requested arbitration seeking a refund of \$1,000. The client then files for bankruptcy. On its face, the automatic stay would not prevent the arbitration from going forward. However, if the attorney is claiming that the refund should be used to offset fees owed in another matter which would effectively result in the collection of money from the client the automatic stay may apply.

If this is not an issue and the debtor/party is not being asked to pay money to the other side in the fee arbitration, the fee arbitration will probably not be affected by the automatic stay. However, given the possible consequences of proceeding in violation of the stay, if there is any doubt as to whether the stay applies, the safer course is to have the non-debtor obtain an appropriate order from the bankruptcy court (usually an order for relief from the automatic stay).

#### **D. What is the Application of the Automatic Stay to Non-Filing Debtors?**

For the most part, the automatic stay will not apply to non-debtors in bankruptcy. For example, the respondents in a fee arbitration proceeding in which the client is seeking a refund of fees include the attorney and the law firm. If, prior to the hearing, the attorney (but not the law firm) files for bankruptcy, the automatic stay may not preclude the arbitration from proceeding solely against the law firm. If, however, the rights of the attorney/ debtor may be adversely affected by proceeding with the arbitration, even if the debtor is dismissed from the arbitration, the automatic stay may apply. The debtor may seek an injunction from the bankruptcy court to, in effect, extend the automatic stay to non-debtors. However, administrators and arbitrators ought not be concerned about such a possibility until they receive

documentation that such an order is being sought or has been granted.

There is an exception, however, when the debtor files under Chapters 12 or 13. Under provisions which are exclusive to these chapters, the protection of the automatic stay is extended to co-debtors in most consumer credit circumstances [Bankruptcy Code sections 1201(a) and 1301(a)]. For example, a husband and wife retained the attorney to prevent the repossession of their family car. After the husband and wife file for fee arbitration, the husband files for bankruptcy. Under Chapters 12 or 13, there is the real possibility that the automatic stay may apply to the wife who has not filed for bankruptcy.

### **E. What is the Duration of the Automatic Stay?**

The automatic stay remains in place for as long as the bankruptcy case remains open or until it is lifted by the bankruptcy court after an application requesting such relief. If the debt is discharged, it is no longer recoverable. Any pending fee arbitration proceeding which had been affected by the automatic stay should be dismissed. If, on the other hand, the court dismisses the bankruptcy, the stay is removed and it would be appropriate to continue with the fee arbitration proceeding.

## **2. The Impact of Bankruptcy Upon the Filing Party's Ability to Continue with the Fee Arbitration Case**

Once the decision has been made that the automatic stay does not apply and the fee arbitration proceeding can go forward, it must be decided whether the debtor/party has the authority to continue. Initially this will depend upon the chapter under which the debtor has filed a bankruptcy proceeding. Under Chapters 11, 12 and 13, a debtor maintains the right, in general, to deal with his or her property in the ordinary course of business, including the right to proceed with an appropriate action to collect a debt (e.g., the fee arbitration proceeding) [Bankruptcy Code sections 1107(a), 1203 and 1303].

Even though the debtor under a Chapter 11, 12 or 13 maintains the right to proceed with the fee arbitration case, if the matter is settled between the parties and no award is issued, the bankruptcy court retains the power to approve or reject the settlement [Bankruptcy Rule 9019]. Thus, if the parties reach a settlement, the fee arbitration file should remain open to allow time for the bankruptcy court to provide final and binding approval of the settlement. If the settlement is not approved, the fee arbitration program is free to bring the arbitration to a conclusion according to its rules.

The vast majority of bankruptcy cases, however, are Chapter 7 matters where the rules are somewhat different and the results may be very different. Under the law, when the bankruptcy is filed, a bankruptcy "estate" is created. Substantially all property rights of the debtor, including the right to collect money as a result of a fee arbitration proceeding, are included in the estate [Bankruptcy Code section 541(a)]. Upon the filing of the bankruptcy, these property rights pass from the debtor to the trustee.

As already noted, under Chapters 11, 12 and 13, the debtor is generally given the right to deal with the pending fee arbitration without supervision by the bankruptcy court. There is no comparable right under Chapter 7. Thus, upon the filing of a Chapter 7 bankruptcy, the right of the debtor to prosecute a fee arbitration where funds are sought from the other side is transferred from the debtor to the trustee in bankruptcy.

It is common practice, however, for the trustee to abandon property of the bankruptcy estate which the trustee deems to be of no practical value. Abandonment can occur in one of two different ways. Whichever way it occurs, the "property" (in this case, the benefit sought by the fee arbitration) reverts back to the debtor, thus allowing the debtor to continue with the fee arbitration case.

Under Bankruptcy Code section 554, the trustee (or the debtor) can apply to the bankruptcy court for specific authorization to allow the trustee to abandon the asset. Generally, before proceeding with the arbitration in a Chapter 7, a copy of the bankruptcy court order permitting the abandonment should be obtained from the debtor.

Commonly, however, a party will seek to invoke the provisions of Bankruptcy Code section 554(c). This section provides for automatic abandonment of any property that is not administered by the trustee when the bankruptcy is closed. A debtor can only obtain the benefits of the automatic abandonment where the asset to be abandoned is included in the schedules required as part of the bankruptcy process. Because most debtors' schedules are somewhat cursory, it can be difficult to ascertain if the asset in question, i.e., the right to recover in the fee arbitration, has truly been scheduled, and hence abandoned. Inasmuch as the Bankruptcy Code also makes clear that any asset not abandoned remains property of the estate [Bankruptcy Code section 554(d)], if there are any doubts as to whether there has been an abandonment, the fee arbitration proceeding should not continue until the debtor has obtained an explicit order of abandonment from the bankruptcy court.