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Protecting Client-Protection Funds from Attorney Bankruptcy

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State bar client-protection funds (CPFs) play a crucial role in upholding the integrity of the legal profession and ensuring that clients have a measure of protection against unethical or dishonest behavior by attorneys. The funds provide a mechanism for clients to seek redress and help maintain public trust in the legal system, and are partially funded through court- or state bar-ordered disciplinary sanctions against attorneys. This article examines the history of state bar CPFs and what occurs when an offending attorney seeks bankruptcy protection, and especially a discharge, against such sanctions.

The Current Problem with California's CPFs

CPFs are funds established by state bars to reimburse clients who lost money or property due to theft or dishonest conduct by an attorney.[1] Although each fund is funded and executed differently,[2] the importance of CPFs are largely self-evident.[3] CPFs not only reimburse wronged clients but preserve public trust in the integrity of the legal profession. As such, "[e]very U.S. jurisdiction now has a fund to compensate clients for such dishonest attorney conduct."[4] Moreover, since 1969, the American Bar Association's Standing Committee on Client Protection has promoted the establishment of CPFs and has published model rules for CPFs since 1981.

CPFs are financed in a variety of ways, but restitution and reimbursement serve a significant role in funding these programs.[5] Perhaps just as important, the restitution debt also operates to deter bad conduct, protect the public, punish dishonest lawyers and even to rehabilitate such attorneys. Without being able to collect this attorney debt, the functions of restitution are undermined and an important source of funding is eliminated for CPFs.

Despite the clear importance of restitution debt to CPFs, the Ninth Circuit in *Kassas v. State Bar of Cal.*[6] held that attorney debt to California's Client Security Fund (herein Cal-CSF) was dischargeable and that 11 U.S.C. § 523(a)(7) did not apply. Prior to this decision, the Cal-CSF listed its most common problems as "funding" and a "high claims volume."[7] Subsequently, attorney Anthony Kassas was able to discharge more than $2 million in debt to the Cal-CSF.

As a result of *Kassas*, the future financial viability of the Cal-CSF is uncertain. Dishonest attorneys are able to and have their debts to the Cal-CSF discharged. To ensure that the Cal-CSF does not collapse, the California State Bar will either have to compensate fewer wronged clients or raise bar fees to have ethical lawyers bear the financial burden of unethical conduct. Despite this ominous message, the California legislature has a way forward through statutory revision by addressing the reasoning in *Kassas*.[8]

Why § 523(a)(7) Did Not Apply in *Kassas*

This was the first appellate court to decide the dischargeability of an attorney's debt under § 523(a)(7) to a state bar's CPF.[9] *Kassas* held that the debt was dischargeable despite the bankruptcy court and bankruptcy appellate panel both holding otherwise. The Ninth Circuit's findings were highly dependent on the precise language of the Cal-CSF statute.[10] The court stated that at every step Cal-CSF was seeking repayment for actual loss and was not concerned with the state's penal interest — a requirement for § 523(a)(7) to apply.

The court had three main reasons for its finding. First, the stated statutory purpose of the Cal-CSF is to "relieve or mitigate [actual] pecuniary losses." Second, the Cal-CSF is focused on subrogation, and as a result, the fund merely stepped into the shoes of

1 For a general overview of CPFs, *see* "Validity and Construction of Statutes or Rules Setting Up Client Security Fund," 53 A.L.R.3d 1298; Leslie C. Levin, "Ordinary Clients, Overreaching Lawyers, and the Failure to Implement Adequate Client Protection Measures," 71 *Am. U.L. Rev.* 447 (2021); Am. Bar Ass'n Ctr. for Pro. Resp., Survey of Lawyers' Funds for Client Protection 2017-19 (herein, the "Survey of Lawyers' CPFs 2017-19").

2 For example, California's CPF is created by statute, funded by California lawyers, pays up to $100,000 excluding interest and other damages to wronged clients, and takes the rights of clients — through subrogation — to pursue legal action against an attorney. Conversely, Nevada's CPF is funded through an annual assessment of active Nevada lawyers, is administered by a volunteer committee, and compensates victims when all other forms of recovery have been exhausted.

3 *See* Model Rules for Lawyers' Funds for Client Protection — Rule 1 (Am. Bar Ass'n) (herein "Model CPF Rules").

4 *See* Model CPF Rules ("A History of Client Protection Rules").

5 *See* Model CPF Rules — Rule 7.

6 49 F.4th 1158 (9th Cir. 2022).

7 Survey of Lawyers' CPFs 2017-19, *supra* n.1.

8 The American Bar Association should also adopt similar changes to its Model CPF Rules. Although these suggested changes are specific to California, the general principles of § 523(a)(7) are applicable. These rules should contemplate the effects of bankruptcy.

9 Bankruptcy courts in four other circuits have found that such debt is not dischargeable. *Snaider v. Conn. Client Sec. Fund Comm. (In re Snaider)*, No. 12-30353 (AMN), 2019 Bankr. LEXIS 3681 (Bankr. D. Conn. 2019); *Pa. Lawyers Fund for Client Sec. v. McKee (In re McKee)*, Nos. 17-10941-AMC, 20-00270-AMC, 2023 Bankr. LEXIS 228 (Bankr. E.D. Pa. 2023); *Virginia v. Young (In re Young)*, 577 B.R. 227 (Bankr. W.D. Va. 2017); *Supreme Court v. Bertsche (In re Bertsche)*, 261 B.R. 436 (Bankr. S.D. Ohio 2000).

10 The *Kassas* court disregarded the California Supreme Court's prior finding in *Brookman v. State Bar*, 46 Cal. 3d 1004 (1988), that CSF debt was rehabilitative and punitive and served as restitution.

the clients acting as a public insurance program. Third, the court found that the precise calculation of the debt showed that the debt was for an actual loss (the lawyer was obligated to reimburse the fund for all the money paid, and there was not a flexible, discretionary remedy tailored to his particular situation). As a result, the court found that the debt was for actual loss because the statute showed more concern for recoupment and did not have enough of a penal purpose.

What Attorney Disciplinary Cost Cases Tell Us About § 523(a)(7)

The dischargeability of debt under § 523(a)(7) turns on whether the debt can be deemed to serve a penal purpose rather than compensate for actual pecuniary loss.[11] Due to the lack of appellate decisions specifically regarding CPF debt, one must look for additional guidance by reviewing cases addressing the dischargeability of disciplinary costs assessed against attorneys for ethical and professional violations. Although debt arising from disciplinary costs is distinguishable from CPF debt,[12] the two debts are sufficiently similar to provide insight into how courts have viewed § 523(a)(7). The two types of debt are similar in that (1) both debts arise from an attorney's poor professional conduct, (2) both result from state statutes, and (3) both debts' dischargeability turns on whether the debt is deemed to have primarily a penal or reimbursement purpose. Furthermore, these disciplinary cost cases are informative in understanding how courts have viewed and analyzed the penal purpose of a debt.

After surveying the cases regarding disciplinary costs,[13] a multitude of factors determine the debt's penal purpose. If the assessment of the debt is discretionary, or if a debt is conditional or readmission to the state bar is based on the repayment of the debt, then the debt is penal and, thus, nondischargeable. However, courts primarily determine the existence of a penal purpose on whether the debt is meant to protect the public and whether the debt serves some punitive, rehabilitative or deterrence function.

The Way Forward, and Finding Hope in *Findley*

Perhaps most informative for these purposes is *In re Findley*,[14] in which the Ninth Circuit reversed its prior decision in *In re Taggart*[15] (which held that disciplinary costs were dischargeable) in response to the California legislature's revision of Cal. Bus. & Prof. Code § 6086.10. The revision inserted a statement of intent stating that disciplinary costs are penalties to promote rehabilitation and protect the public.[16] The *Findley* court found that the revision was enough to undermine the Ninth Circuit's prior decision because the revision clarified the legislature's intent, demonstrated that the California legislature strongly disagreed with the prior decision, and rid the requisite statute of the distinction the prior case precedent identified.[17]

The *Findley* case demonstrates that under § 523(a)(7), an insertion of a statement of intent into the requisite statute by the California legislature is enough to transform a debt from dischargeable to nondischargeable. To transform Cal-CSF debt into nondischargeable debt, the California legislature should insert a statement of intent expressing that an attorney's debt to the CSF is a penalty to promote the rehabilitation of attorneys and protect the public. Additional language regarding the debt being punitive and for deterrence would strengthen the likelihood of Cal-CSF debt being deemed nondischargeable.

Recommended Changes to the Cal-CSF Statute

Ultimately, revision of the Cal-CSF statute is the only remedy for such debt to be nondischargeable under § 523(a)(7). The Ninth Circuit's holding in *Kassas* that Cal-CSF debt did not primarily serve a penal purpose and was for actual pecuniary loss was highly specific to the Cal-CSF statute. By undermining the specific reasoning with a statutory revision, Cal-CSF debt can be transformed into a nondischargeable debt. The California legislature has done this before with attorney disciplinary cost debt. These suggested revisions are crafted to address the court's reasoning in *Kassas*. Here are a few suggested revisions:

1. (Necessary) Insert a new statement of intent into the Cal-CSF statute (as the California legislature did in response to *Taggart*) and eliminate the statement that the fund's purpose is to compensate for pecuniary loss. The statement should indicate that an attorney's debt to the Cal-CSF is a penalty to promote the rehabilitation of the attorney and to protect the public. The statement should also indicate that the debt is punitive and for deterrence purposes.

11 To be exempted from discharge under § 523(a)(7), the debt must: (1) be a fine, penalty or forfeiture; (2) be owed to or for the benefit of a governmental unit; (3) not be compensation for an actual pecuniary loss; and (4) not be one of the identified tax exceptions. Thus, for a debt to be nondischargeable, it must be penal in nature (the debt may arise from a criminal or civil proceeding). In fact, the emphasis of a penal purpose arises from *Kelly v. Robinson*, 479 U.S. 39, in which the Supreme Court found that criminal restitution was not dischargeable because the Bankruptcy Code was not intended to interfere with state police powers. The Court reasoned that the Code did not interfere with states' need to be able to punish and deter bad conduct and rehabilitate individuals to protect the public. *Kelly v. Robinson* acts as the underlying foundation to most of the § 523(a)(7) case law and is thus the reason why these cases turn on a debt's penal purpose.

12 Debt arising from disciplinary costs results from a government unit (the state bar) directly assessing the costs against the attorney debtor after prosecuting the attorney for ethical violations, whereas the debt to a CSF arises after the fund pays money to a wronged client and subrogates the rights against the attorney from the client (this is explicitly done in California, but not in all states), then seeks an award or payment from the attorney debtor. In sum, the debt from the disciplinary costs is directly from the governmental unit, whereas the CSF debt is indirectly from the state bar, as it originates from the wronged client.

13 *Richmond v. N.H. Supreme Court Comm. on Prof'l Conduct*, 542 F.3d 913 (1st Cir. 2008); *United States HUD v. Cost Control Mktg. & Sales Mgmt.*, 64 F.3d 920, 928 (4th Cir. 1995); *State Bar v. James (In re James)*, Nos. 16-40752, 16-4076, 2017 Bankr. LEXIS 3521 (Bankr. E.D. Tex. 2017); *Hughes v. Sanders*, 469 F.3d 475, 478 (6th Cir. 2006); *Osicka v. Off. of Law. Regul*, 25 F.4th 501 (7th Cir. 2022); *Disciplinary Bd. v. Feingold (In re Feingold)*, 730 F.3d 1268 (11th Cir. 2013).

14 *State Bar v. Findley (In re Findley)*, 593 F.3d 1048 (9th Cir. 2010).

15 *State Bar v. Taggart (In re Taggart)*, 249 F.3d 987 (9th Cir. 2001).

16 The California legislature inserted subsection (e), which states in part that "costs imposed pursuant to this section are penalties ... to promote rehabilitation and to protect the public." *Findley* at 1052.

17 *Id.* at 1052-53. The prior statute had two different sections that allowed for the imposition of fees on disciplined attorneys — one for fines (§ 6086.13) and one for costs (§ 6086.10). Due to the differences in the plain language of the Code sections and the different legislative histories, the court concluded that the disciplinary cost debt was significantly distinct and different from fines in § 6086.13, and thus, the disciplinary cost debt was not a fine or penalty under § 523(a)(7). *State Bar v. Taggart (In re Taggart)*, 249 F.3d 987, 991-92 (9th Cir. 2001). The *Taggart* court further noted the similarity between disciplinary costs and awards to prevailing parties in civil suits. *Id.* at 992. However, the statutory distinctions made by the *Taggart* court were undermined. The statutory revision, as discussed in *Findley*, clearly changed the legislative history and expressly provided that the debt had a penal purpose. Moreover, the revision inserted language that equated disciplinary costs with monetary sanctions under § 6086.13, which further proved the legislature's penal intent. Lastly, the *Findley* court dismissed the similarities between disciplinary costs and awards to prevailing parties in civil suits. The court reasoned that looking at the similarities was only necessary to discern legislative intent, which had been made clear by the statutory revision. *Findley* at 1053-54.

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2. (Necessary) Maintain the conditional reinstatement to the state bar. Thus, keep the requirement that the attorney must make full payment/restitution with the CSF to be readmitted to the California Bar or to continue practicing.
3. (Highly Suggested) The debt to the Cal-CSF should be tailored to the facts and harm done to highlight the penal nature of the debt. Furthermore, the assessment of the debt should be discretionary and not automatically and precisely calculated to demonstrate that the state bar is more concerned with protecting the public, rather than with recouping the moneys paid out.
4. (Optional) Eliminate the subrogation language or alternatively keep the language and clarify that this language is present to ensure that wronged clients are paid and the state bar is the only person pursuing claims against the attorney and maintaining a monopoly on disciplining members of the state bar.

Conclusion

While this article has discussed the policy usage in California, other states would benefit from having statutes that create CPFs containing the aforementioned suggested provisions. These suggested provisions highlight a penal intent by directly incorporating the factors identified in the survey of § 523(a)(7) cases: rehabilitation, deterrence or punitive function to protect the public; discretionary assessment of the debt; and requiring repayment of readmission to the bar. In this way, dishonest attorneys will be unable to have their debts to the CPF discharged. abi