**National Client Protection Organization**

**Fall Workshop September 2024**

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**CLIENT PROTECTION FUND-BANKRUPTCY ISSUES**

1. **Automatic Stay Issues**

What happens if a disciplined attorney files a Chapter 7 or 13 Bankruptcy Petition and there is either a pending investigation/complaint filed by a former client seeking a Client Protection Fund award, or the former client files the CPF claim during the pendency of the bankruptcy case? Is the State Bar’s Client Protection Fund proceeding stayed?

**11 U.S.C. § 362**

Under 11 U.S.C. §362, most actions to collect prepetition debt is stayed by the bankruptcy filing. Exceptions to the stay are listed in the statute.

1. **Government Police and Regulatory Power Exception-11 U.S.C. §362 (b)(4)**:

Under 11 U.S.C.§362 (b)(4), a governmental unit’s or organization’s proceeding to exercise police and regulatory power, “including the enforcement of a judgment other than a money judgment, obtained in an action or proceeding by the governmental unit to enforce such governmental unit’s or organization’s police or regulatory power” is excepted from the automatic stay.

NOTE: A "governmental unit" is defined in the Bankruptcy Code as: United States; State; Commonwealth; District; Territory; municipality; foreign state; department, agency, or instrumentality of the United States (but not a United States trustee while serving as a trustee in a case under this title), a State, a Commonwealth, a District, a Territory, a municipality, or a foreign state; or other foreign or domestic government. [11 U.S.C.S. § 101(27)](https://plus.lexis.com/document/midlinetitle/?pdmfid=1530671&crid=2e08ba41-e6be-4d4b-8399-ce3752279d36&docfullpath=%2Fshared%2Fdocument%2Fcases%2Furn%3AcontentItem%3A4DVN-9910-TVXM-Y2D4-00000-00&componentid=6401&prid=5ee68030-fc37-48d5-b098-f340c4fd66ff&ecomp=4y7g&earg=sr12)

Courts have held that, under 11 U.S.C. §362(b)(4), a State Bar is a governmental unit with disciplinary proceedings that are enforcements of police or regulatory power. *In re Wade,* 948 F. 2d 1123.

If the CPF action is considered an exercise of government “police and regulatory power” then the CPF is likely exempt from the stay. The Virginia State Bar is a governmental agency of the Commonwealth of Virginia, and the Client Protection Fund was established to provide a source of funds available for former clients harmed by their attorney’s misconduct. Therefore, it follows that a CPF claim proceeding would fall under the exception to the stay under 11 U.S.C. §362 (b) (4).[[1]](#footnote-1) However, there are issues:

1. The CPF action is essentially an action brought by an individual seeking funds from the CPF-the claimant is not the government, and the claimant is not seeking collection against the wrongdoing attorney. See Pt. 6, §IV, para. 16 of the Rules of the Supreme Court of Virginia
2. However, at the conclusion of a CPF proceeding a debt may result against the debtor (former attorney) since the State Bar CPF is subrogated to the claimant’s claim against the former attorney.
3. Also, what if the former attorney, debtor, lists the former client’s claim in the bankruptcy petition before there is a CPF award, and there is no objection to the discharge of the debt is filed and adjudicated, then the claimant’s claim may be discharged. If the claim is discharged, can the claimant continue to pursue a CPF claim with the State Bar?

Strategy: Argue that the CPF proceeding is an attorney disciplinary proceeding under the State Bar, a governmental unit, and such proceeding is an exercise of government police and regulatory power (protecting the public from wrongdoing attorneys) and therefore it is exempt from the automatic bankruptcy stay under 11 U.S.C. §362 (b) (4).

Discussion:

1. **Discharge Issues of Client Protection Fund Awards**

Generally, there are two types of bankruptcy cases filed by most individuals-Chapter 7 and Chapter 13.

1. **CHAPTER 7: Chapter 7 Exception to Discharge- 11 U.S.C. §523 (a)(7)**

The exceptions to a Chapter 7 bankruptcy discharge are listed in 11 U.S.C. §523.[[2]](#footnote-2) The discharge exception that is applicable to State Bar disciplinary fines and penalties is 11 U.S. C. §523 (a)(7) which provides that:

“A discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b)of this title does not discharge an individual debtor from any debt-

(7) to the extent such debt is for a fine, penalty, or forfeiture payable to and for the benefit of a governmental unit, and is not compensation for actual pecuniary loss, …”

 In order for a debt to be excepted from a bankruptcy discharge under operation of 11 U.S.C. § 523(a)(7) the debt must pass three tests:

 -Is it a fine or penalty?

 -Is it payable to and for the benefit of a governmental unit?

 -Is it not compensation for actual pecuniary loss?

1. **Is the Client Protection Fund Debt (CPF) a “Fine or Penalty” under 11 U.S.C. §523(a)(7)?**
2. What is the CPF in Virginia?

Answer: Pt. 6, §IV, Para.16 of the Rules of the Supreme Court of Virginia provides that: “The Council may establish a Client’s Protection Fund for the purposes of reimbursing all or part of losses sustained by a client or other person or entity to whom a fiduciary duty is owed as a result of dishonest conduct of a member of the Virginia State Bar. Pt. 6, §IV, Para.16 of the Rules of the Supreme Court of Virginia.

1. Proceedings for considering Client Protection Fund or Client Security Fund claims and making awards out of the Fund are disciplinary proceedings held by a State Bar. See: *Supreme Court of Ohio v.Bertsche (In re Bertsche)* 261 B.R. 436 (Bankr. S.D. Ohio 2000).
2. Key Element in Virginia: The CPF Debt Must be repaid in full before a bar license can be reinstated.

Under Pt.6, §IV, Para. 13-25 (E) of the Rules of the Supreme Court of Virginia, an attorney whose license has been revoked, may petition the Clerk of the Supreme Court for reinstatement of the bar license provided that the requirements for eligibility for consideration of reinstatement listed in Para. 13-25 (F) have been satisfied. One of the requirements in subparagraph (F) (5) is that “The Petitioner has reimbursed the Bar’s Client Protection Fund for any sums of money it may have paid as a result of Petitioner’s Misconduct.”

The requirement for paying back the CPF Fund in full for being able to petition for reinstatement of a bar license is a critical factor in the court’s determinations that the CPF debt is a fine or penalty. The rationale is that the requirement is a means of protecting the public against wrongdoing attorneys. See *Virginia v. Young (In re Young)* 577 B.R. 227 (Bankr. W.D. VA 2117). In the *Young* case, the court followed the line of decisions holding the attorney disciplinary proceedings, although they are civil proceedings, result in costs that are penal in nature and are like criminal restitution that is not dischargeable under the Supreme Court ruling in *Kelly v. Robinson*, 479 U.S. 36, 197 S. Ct. 353, 93 L. Ed. 2d 216 (1986). The *Young* court stated in the opinion that:

Many courts have followed *Kelly* and held that the costs of attorney disciplinary proceedings are nondischargeable under *11 U.S.C. § 523(a)(7)*. See *The Disciplinary Board of the Supreme Court of Penn. v. Feingold (In re Feingold), 730 F.3d 1268 (11th Cir.2013)* ("The rationale of *Kelly* extends to cost assessments arising out of attorney disciplinary proceedings. First, although attorney disciplinary proceedings are not criminal in nature, the two types of proceedings share some common goals"); *Richmond v.* *New Hampshire Supreme Court Committee on Prof'l* *Conduct, 542 F.3d 913, 919-20 (1st Cir. 2008)*; *Florida* *Bar v. Cillo (In re Cillo), 159 B.R. 340, 343 (Bankr. M.D. Fla. 1993)*; *Supreme Court of Ohio v. Bertsche (In re Bertsche), 261 B.R. 436 (Bankr. S.D. Ohio 2000)*; *Attorney Registration & Disciplinary Comm'n v. Lewis (Inre Lewis), 151 B.R. 200, 203 (Bankr. C.D. Ill. 1992)*; butsee *Love v. Scott (In re Love), 442 B.R. 868 (Bankr. M.D. Tenn. 2011)* (finding that a debt for the costsassociated with a disciplinary proceeding were not excepted from discharge).

*Young,* at 230*.*

 The *Young* decision is the only case decision by a bankruptcy court or any federal court in the Fourth Circuit addressing the issue of whether a CPF Fund debt is dischargeable in bankruptcy. The analysis used by the *Young* court was applied by the U.S. District Court of the Eastern District of Pennsylvania in a 2023 decision holding that a Client Security Fund Debt was not dischargeable in bankruptcy under 11 U.S.C. §523 (a)(7) in *Pa. Laws Fund for Client Security v. McKee,* 2023 U.S. Dist. LEXIS 180523.

As in Virginia as cited in the *Young* opinion, so in *Mckee,* Pennsylvania also has a rule requiring the attorney to pay the Security Fund debt in full before the attorney’s bar license can be reinstated. The *McKee* court cited the rule:

*[Pennsylvania R.D.E.](https://plus.lexis.com/api/document?collection=statutes-legislation&id=urn%3AcontentItem%3A6BKY-GFY3-RVDF-8271-00009-00&context=1530671)* *[531](https://plus.lexis.com/api/document?collection=statutes-legislation&id=urn%3AcontentItem%3A6BKY-GFY3-RVDF-8271-00009-00&context=1530671)* states that an attorney who is suspended for dishonest conduct cannot be reinstated by the Supreme Court "until the Covered Attorney has paid in full a *penalty* to the Fund assessed in the amount of all disbursements made from the Fund with respect to the Dishonest Conduct of such Covered attorney, plus 10% per annum interest." [*R.D.E. 531*](https://plus.lexis.com/api/document?collection=statutes-legislation&id=urn%3AcontentItem%3A6BKY-GFY3-RVDF-8271-00009-00&context=1530671)(emphasis added).

Id., at 35.

 **Conclusion:** There is solid judicial precedent to support a finding that a Client Protection Fund (Security Fund) debt owed by a disciplined attorney is penal in nature, is designed to protect the public, and is therefore, a penalty under 11 U.S.C. §523 (a)(7).

1. **Is the CPF debt payable to and for the benefit of a governmental unit?**

In Virginia, the CPF debt is payable to the Virginia State Bar.

The Virginia State Bar, under operation of Va. Code §54.1-3910, is administrative

 agency of the Supreme Court of Virginia, and a governmental agency of the Commonwealth of Virginia with the purpose of investigating attorney violations of the ethical rules of conduct established by the Supreme Court of Virginia. Therefore, The Virginia State Bar is a governmental unit as the term is used under 11 U.S.C. §523 (a) (7). Other State Bars are also “governmental units.”[[3]](#footnote-3)

1. **Is payment of the CPF debt compensation for actual pecuniary loss?**

This third requirement- that the repayment of the CPF debt is not compensation for pecuniary loss- is one that courts have reached different conclusions.

How do we as attorneys for the Bar, deal with the argument that the repayment of the CPF debt by the attorney is a recovery of funds that were expended by the Bar to pay the claimants, the former clients of the disciplined attorney?

Answer: Use the analysis in *Young and McKee* and cite those cases for support. Cite the reasoning that the purpose of repayment is penal, rehabilitative, and serves to protect the public.

 In *Young,* the Court stated that:

In order to determine whether the debt is compensation for actual pecuniary loss, courts have looked to the primary purpose of the debt. *Feingold, 730 F.3d at* *1275*. The key element in this analysis is whether

the VSB, through the Fund, aimed at penalizing the Debtor. As several other courts have held in examining this element, "[e]ven where a debt is intended to help defray the expense of government, it may not be dischargeable if its primary purpose is penal." *United States HUD v. Cost Control Mktg. & Sales Mgmt., 64 F.3d 920, 928 & n.3 (4th Cir. 1995)*, cert. denied, *517 U.S. 1187, 116 S. Ct. 1673, 134 L. Ed. 2d 777 (1996)* (noting that the "actual pecuniary loss phrase in *§ 523(a)(7)* refers to the government's pecuniary loss"); *see Grievance Comm'n of Maryland v. Smith (In re Smith), 317 B.R. 302, 312* ("[T]he primary purpose forimposing costs is penal, and not compensatory, in thatan attorney's rehabilitation is encouraged through thecondition to reinstatement imposed by the judgment.The mere fact that a penal sanction is calculated by reference to actual costs does not, in and of itself, transform the penalty into compensation for pecuniary loss."). In *Kelly*, the nondischargeable restitution order was calculated by reference to the victim's actual loss, but this fact was not outcome-determinative. Rather, what matters is the protection of the public, which the Supreme Court of Virginia has articulated as its primary

goal. See *Moseley, 280 Va. at 3*.

*Young* at 230.

The Court in *Young,* concluded that the repayment of the CPF debt is not compensation for pecuniary loss since the purpose of the repayment is tied to the requirement that it be paid before an attorney can apply for reinstatement of license, which is designed to provide a layer of protection for the public from wrongdoing attorneys. His conclusion was:

 Here, consistent with its Rules on reinstatement, and

consistent with its articulated policy of protecting the

public, the Supreme Court of Virginia approved the

Debtor's petition for reinstatement conditioned on

repaying the full debt owed to the Fund. This action by

the Supreme Court shows that the debt is not just to

compensate the Fund for costs but also a consequence

to the Debtor for violations of ethical rules of conduct

while he was a licensed attorney. This reinstatement

order and its reimbursement obligation serves society's

broader rehabilitative and penal goals and cannot be

viewed narrowly as merely representing compensation

to the victims.

 *Young* at 232.

 The same conclusion, that the repayment is penal and rehabilitative was reached by the U.S. District Court in *McKee*, citing *Young* as precedent. See *McKee* at 39.

Be prepared to distinguish your case from the decision reached by the Ninth Circuit in *Kassas v. State Bar of California,* 49 F.4th 1158 (9th Cir. 2022). The *McKee* Court distinguished the facts in *Kassas* from its facts by pointing out that the California Security Fund was limited to reimbursing the attorney’s former clients only for “actual pecuniary loss” and applies interest but the Pennsylvania Client Security Fund rule also adds a 10% annual interest as a “penal tool.” See *McKee* at 37. The *McKee* court also pointed out that the Pennsylvania rules require repayment of the Client Security Fund debt as a requirement of reinstatement of license, and therefore, the repayment requirement “…focuses on the disposition of the attorney rather than the victim, further illustrating that the purpose of the payment is to discipline the attorney rather than compensate the victim.” *McKee* at 38.

Ninth Circuit: The Client Security Fund debt is dischargeable as it is reimbursement for pecuniary loss. *Kassas v. State Bar of California,* 49 F.4th 1158 (9th Cir. 2022).

However, as stated above, the California Client Security Fund Rule’s purpose is expressly tied to recover of “pecuniary losses.” The court cited the Rule, stating that: “First, the stated purpose of the CSF is "to relieve or mitigate *pecuniary losses* caused by the dishonest conduct of active members of the State Bar. Cal. Bus. & Prof. Code § 6140.5(a)” *Kassas* at 1163. The *Kassas* court also pointed out that the California Bar Rule was limited to claimant’s actual loss of money or property and that the Bar had a process for determining the actual pecuniary loss. Id. The Court also discussed how criminal restitution awards are not determined with the extent of “precision” that is used by the California Bar in determining the pecuniary loss under the Client Security Fund rules. Id. Therefore, although the California Bar rules also require repayment of the security fund debt as a prerequisite to license reinstatement, the fund debt repayment in *Kassas* was held to be a dischargeable debt and not excepted from discharge under 11 U.S.C. §523 (a)(7) as the repayment was expressly a reimbursement for pecuniary loss. In so holding, the Court stated that: “The CSF, by contrast, requires attorneys to reimburse the CSF only for the amount the CSF paid the attorney's clients, an amount limited to actual ‘pecuniary loss.’ *Cal. Bus. & Prof. Code §6140.5 (b).” Kassas* at 1164-1165.

1. **CHAPTER 13: Discharge of Client Protection Fund Debts in Chapter 13 Bankruptcy**

The CPF debt is discharged in Chapter 13. 11 U.S.C. §1328(a)(2)

 Section 1328 (a) provides that a discharge entered by the court in a Chapter 13 bankruptcy case discharges debts except those listed in the subparagraphs. Subparagraph (2) excepts debts that fall under Section 507(a)(8) and those listed in the following subsections of Section 523(a): (1)(B),(1)(C), (2), (3), (4),(5),(8), or (9). The government penalty exception to discharge is listed under Section 523(a)(7), so it is not excepted from a Chapter 13 discharge.

1. What if the CPF award is entered after the bankruptcy filing, but is based on a claim involving prepetition conduct of the debtor? Is the CPF award considered a post-petition debt, and therefore, would not be subject to discharge?
2. CPF award entered before the Chapter 13 filing but the debtor failed to list the CPF award in the bankruptcy petition?

 **If the debt is not listed and the State Bar (or Disciplinary Board …) does not receive notice of the bankruptcy filing in time to timely file a proof of claim-then the CPF debt is not discharged. See 11 U.S.C. §1328 (a)(2) and §523(a)(3)(B).**

1. What to do if you are notified of a Chapter 13 filing?
2. File Proof of Claim with supporting documents. Check the filing date and the deadline for filing proof of claims by governmental units. If in timely- file a proof of claim with supporting documents.
3. Contact bankruptcy counsel for review.
4. **Disbarred Attorney Applies for Reinstatement After Chapter 13 Discharge**

This is an issue that may arise in the future.

11 U.S.C. §525(a) prohibits governmental units from refusing to renew a license of a debtor who has discharged a debt owed to the unit. 11 U.S.C. §525(a) states:

1. Except as provided in the Perishable Agricultural Commodities Act, 1930 [[7 USCS §§ 499a](https://plus.lexis.com/document?pdmfid=1530671&pddocfullpath=%2Fshared%2Fdocument%2Fstatutes-legislation%2Furn%3AcontentItem%3A61YW-PX73-GXJ9-32KX-00000-00&pdcontentcomponentid=6362&ecomp=87ttk&earg=pdsf&prid=4fb25bfd-0392-462d-a1ae-b3d67f6d16af&crid=dbbd57c8-7b21-47f4-b3c9-e99e0c382fd9&pdsdr=true) et seq.], the Packers and Stockyards Act, 1921 [[7 USCS §§ 181](https://plus.lexis.com/document?pdmfid=1530671&pddocfullpath=%2Fshared%2Fdocument%2Fstatutes-legislation%2Furn%3AcontentItem%3A61YW-PX73-GXJ9-32KX-00000-00&pdcontentcomponentid=6362&ecomp=87ttk&earg=pdsf&prid=4fb25bfd-0392-462d-a1ae-b3d67f6d16af&crid=dbbd57c8-7b21-47f4-b3c9-e99e0c382fd9&pdsdr=true) et seq.], and section 1 of the Act entitled “An Act making appropriations for the Department of Agriculture for the fiscal year ending June 30, 1944, and for other purposes,” approved July 12, 1943 [[7 USCS § 204](https://plus.lexis.com/document?pdmfid=1530671&pddocfullpath=%2Fshared%2Fdocument%2Fstatutes-legislation%2Furn%3AcontentItem%3A61YW-PX73-GXJ9-32KX-00000-00&pdcontentcomponentid=6362&ecomp=87ttk&earg=pdsf&prid=4fb25bfd-0392-462d-a1ae-b3d67f6d16af&crid=dbbd57c8-7b21-47f4-b3c9-e99e0c382fd9&pdsdr=true)], a governmental unit may not deny, revoke, suspend, or refuse to renew a license, permit, charter, franchise, or other similar grant to, condition such a grant to, discriminate with respect to such a grant against, deny employment to, terminate the employment of, or discriminate with respect to employment against, a person that is or has been a debtor under this title [[11 USCS §§ 101](https://plus.lexis.com/document?pdmfid=1530671&pddocfullpath=%2Fshared%2Fdocument%2Fstatutes-legislation%2Furn%3AcontentItem%3A61YW-PX73-GXJ9-32KX-00000-00&pdcontentcomponentid=6362&ecomp=87ttk&earg=pdsf&prid=4fb25bfd-0392-462d-a1ae-b3d67f6d16af&crid=dbbd57c8-7b21-47f4-b3c9-e99e0c382fd9&pdsdr=true) et seq.] or a bankrupt or a debtor under the Bankruptcy Act, or another person with whom such bankrupt or debtor has been associated, solely because such bankrupt or debtor is or has been a debtor under this title [[11 USCS §§ 101](https://plus.lexis.com/document?pdmfid=1530671&pddocfullpath=%2Fshared%2Fdocument%2Fstatutes-legislation%2Furn%3AcontentItem%3A61YW-PX73-GXJ9-32KX-00000-00&pdcontentcomponentid=6362&ecomp=87ttk&earg=pdsf&prid=4fb25bfd-0392-462d-a1ae-b3d67f6d16af&crid=dbbd57c8-7b21-47f4-b3c9-e99e0c382fd9&pdsdr=true) et seq.] or a bankrupt or debtor under the Bankruptcy Act, has been insolvent before the commencement of the case under this title [[11 USCS §§ 101](https://plus.lexis.com/document?pdmfid=1530671&pddocfullpath=%2Fshared%2Fdocument%2Fstatutes-legislation%2Furn%3AcontentItem%3A61YW-PX73-GXJ9-32KX-00000-00&pdcontentcomponentid=6362&ecomp=87ttk&earg=pdsf&prid=4fb25bfd-0392-462d-a1ae-b3d67f6d16af&crid=dbbd57c8-7b21-47f4-b3c9-e99e0c382fd9&pdsdr=true) et seq.], or during the case but before the debtor is granted or denied a discharge, or has not paid a debt that is dischargeable in the case under this title [[11 USCS §§ 101](https://plus.lexis.com/document?pdmfid=1530671&pddocfullpath=%2Fshared%2Fdocument%2Fstatutes-legislation%2Furn%3AcontentItem%3A61YW-PX73-GXJ9-32KX-00000-00&pdcontentcomponentid=6362&ecomp=87ttk&earg=pdsf&prid=4fb25bfd-0392-462d-a1ae-b3d67f6d16af&crid=dbbd57c8-7b21-47f4-b3c9-e99e0c382fd9&pdsdr=true) et seq.] or that was discharged under the Bankruptcy Act.

11 U.S.C. §525(a).

Related Case Law:

The Federal Communication Commission’s cancellation of broadband licenses based on debtor’s failure to make payments on a discharged debt is a violation of 11 U.S.C. §525(a). *Federal Communications* *Commission v. Nextwave Personal Communications, Inc., et. al.,* 537 U.S. 293, 123 S. Ct. 832 (2003).

1. See *Pt. 6, §IV, ¶16, Rules of the Supreme Court of Virginia*. [↑](#footnote-ref-1)
2. See the Code Section, attached. [↑](#footnote-ref-2)
3. *Betts v. Attorney*  *Registration and Disciplinary Comm'n,* [165 B.R. 870](https://www.courtlistener.com/opinion/1942651/betts-v-attorney-reg-and-disciplinary-comn/),873 (N.D.I11.1994); *In re Borowski,* [216 B.R. 922](https://www.courtlistener.com/opinion/1545128/in-re-borowski/) (Bankr.E.D.Mich. 1998); *In re Haberman,* [137 B.R. 292](https://www.courtlistener.com/opinion/1872933/in-re-haberman/), 294 (Bankr.E.D.Wis.1992); *Fla, Bar v. Cillo (In re Cillo),* [159 B.R. 340](https://www.courtlistener.com/opinion/1547325/in-re-cillo/), 342 (Bankr. M.D.Fla.1993); *In re Williams,* [158 B.R. 488](https://www.courtlistener.com/opinion/1813090/in-re-williams/), 490 (Bankr.D.Idaho 1993).  [↑](#footnote-ref-3)