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Bankruptcy Law

A Split That Affects All Attorneys

Bankruptcy Courts differ on perfection requirement for attorneys' liens

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Attorneys loath to read Bankruptcy Court opinions, or even to familiarize themselves with bankruptcy-type issues, have cause for discomfit because a recent split between Bankruptcy Courts implicates an issue with which all attorneys should be familiar: perfection of attorneys' liens.

In *Tannenbaum v. Smith* (*In re Smith*), 263 B.R. 71 (Bankr. D.N.J. 2001), a Bankruptcy Court held that an attorney's lien remains valid against third parties notwithstanding a failure to comply with New Jersey attorneys' lien law. In so ruling, the court expressly disagreed with *Hoffman & Schreiber v. Medina*, 224 B.R. 556 (Bankr. D.N.J. 1998), in which a district court affirmed a contrary holding, that is, that such a failure renders the lien unperfected.

New Jersey Law

N.J.S.A. 2A:13-5 provides that after the filing of a complaint or third-party complaint or the service of a pleading containing a counterclaim or

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cross-claim, the attorney appearing for the party instituting the action or maintaining the third-party claim or counterclaim or cross-claim shall have a lien for compensation on the action, cause of action, claim or counterclaim or cross-claim.

The action or claim shall contain and attach to a verdict, report, decision, award, judgment or final order in her client's favor and the proceeds thereof. Further, the last sentence of the statute provides that the court in which the action or other proceeding is pending may, on petition of the attorney, determine and enforce the lien.

New Jersey courts have interpreted that last sentence as a requirement that attorneys must file an application for the determination and enforcement of the lien during the pendency of the underlying proceeding. In *Martin v. Martin*, 335 N.J. Super. 212 (App. Div. 2000), the court said "[W]here the determination or enforcement of an attorney's lien is sought ... [t]he attorney should make application to the court, as a step in the proceeding of the main cause, by way of petition."

Courts have denied entitlement to an attorney's lien in cases in which the attorney failed to fulfill this requirement. In *Cole, Schotz, Bernstein, Meisel & Forman, P.A. v. Owens*, 292 N.J. Super. 453 (App. Div. 1996), for example, the court found an attorney's lien invalid where "[the attorney] initially moved for the imposition of a lien instead of filing a complaint." And in

Panarello v. Panarello, 245 N.J. Super. 318 (Ch. Div. 1990), the court noted that N.J.S.A. 2A:13-5 further provides that for a lien to be effective it must be brought during the time the action or other proceeding is pending.

In 1978, the New Jersey Supreme Court adopted Rule 1:20A-6, providing in relevant part that prior to institution of an action to recover a fee, an attorney shall notice her client of the option to pursue fee arbitration, and that if the client does not elect to pursue this remedy, the attorney's complaint shall allege service of the required notice.

Courts have also denied entitlement to an attorney's lien in cases in which the attorney failed to send a "Pre-Action Notice" in accordance with this rule. For example, in *Mateo v. Mateo*, 281 N.J. Super. 73 (App. Div. 1995), the court stated that "An action for attorney's fees must be dismissed where the attorney does not allege that he or she gave the client notice of the availability of the Fee Arbitration Committee proceedings."

Hoffman: Failure To Fulfill Requirements is Prejudicial

In *Hoffman*, a district court addressed the issue of whether a Bankruptcy Court had correctly determined that a failure to comply with these requirements rendered a firm's attorney's lien unperfected and hence, unsecured.

The firm had represented the debtor

in a prepetition divorce proceeding, in which it had filed a counterclaim for judgment of divorce. The proceeding culminated in the issuance of a final judgment, pursuant to which the debtor received a one-third interest in the real property at issue, equivalent to \$23,151.19.

During the proceeding, the firm incurred legal fees in the amount of \$44,701. Shortly before the debtor filed her bankruptcy petition, the firm sent to the debtor a letter indicating its intention to institute a lawsuit for the purpose of collecting its fees.

Following the petition filing, the firm filed a proof of claim in which it asserted a secured claim in the amount of \$23,151, representing the amount awarded in the divorce proceeding, and an unsecured claim for the balance owed. Thereafter, the debtor filed a motion, in which the trustee joined, to determine the extent and validity of the firm's lien. They argued that the firm had failed to perfect its lien on the amount awarded in the divorce proceeding.

The Bankruptcy Court deemed the lien unperfected by virtue of the firm's failure to commence an action to determine and enforce the lien in the underlying divorce proceeding. Accordingly, it concluded that the entire amount owed to the firm constituted a general unsecured claim.

The firm appealed the decision. It argued that "under the plain language of the statute, its attorney's lien was perfected as of the date it commenced legal proceedings on debtor's behalf, which in this case was the date the Counterclaim was filed." The firm argued, in the alternative, that "even if [the] Court finds that the Pre-Action Notice is a prerequisite to perfection under §2A:13-5, it has satisfied this requirement, as it is undisputed that it served debtor with a letter indicating that it intended to bring an action to recover its attorney's fees just prior to the filing of the bankruptcy Petition."

The district court rejected both arguments. First, it found that, although "under §2A:13-5, the right to assert an attorney's lien arises at the time of the commencement of the services by the attorney ... creation of an interest in property is not synonymous with per-

fection of that interest." "In other words," it asserted, "the statute may require the attorney to perform some affirmative act or comply with some procedure to perfect the interest which is created under the statute."

With regard to the second argument the court observed, "if we agree with the legal conclusion reached by the bankruptcy court, we must hold that in order to perfect a lien under §2A:13-5,

As a precautionary measure, attorneys should send a Pre-Action Notice and submit an application for a determination of the right to an attorney's lien.

the attorney is required not only to serve a Pre-Action Notice to the client, but also make an application to the court during the course of the main action for a determination of the attorney's right to an attorney's lien under §2A:13-5."

The court confirmed the Bankruptcy Court's conclusion finding that counsel will "lose" the right to an attorney's lien if it fails to properly follow the applicable procedures. The court determined that these procedures include not only the Pre-Action Notice requirement under Rule 1:20A-6 but also the commencement of a petition during the pendency of the underlying proceeding.

Recognizing that New Jersey courts have held that an attorney lacks an entitlement to a lien in the absence of compliance with these procedures, the district court held that "it follows that

until those procedural requirements are satisfied, the right to an attorney's lien remains unperfected."

Accordingly, after noting that the firm had failed to file the necessary petition in the underlying divorce proceeding, the court concluded that the firm's entire claim warranted unsecured status only.

Smith: Failure To Fulfill Requirements Is Innocuous

In *Smith*, a law firm had represented the debtor in her prepetition suit based on a motor vehicle accident. Following the debtor's bankruptcy petition filing, the firm settled the suit for \$85,000, approximately \$56,000 of which it disbursed to the debtor, and approximately \$26,000 of which, representing its contingency fee and costs, it retained.

The firm asserted an attorney's lien in the proceeds of the settlement to the extent of its contingency fee. In opposition, the trustee invoked 11 U.S.C. 545(2). That subsection provides in relevant part that "[a] trustee may avoid the fixing of a statutory lien on property of the debtor to the extent that such lien is not perfected . . . at the time of the commencement of the case against a bona fide purchaser that purchase such property." The trustee argued that the firm's attorney's lien was unperfected and unenforceable against a bona fide purchaser and, hence, was avoidable by virtue of the firm's failure to file a Pre-Action Notice.

The Bankruptcy Court disagreed. It found that "[a]lthough New Jersey case law requires service of a pre-action notice as a condition precedent to an action on an attorney's lien, that requirement relates to *enforcement* of the lien, not perfection of it." "The *Cole, Schotz* case and those on which it relies," the court maintained, "presumably adopted that judicial rule on the belief that before an attorney's lien can be enforced, there should be a determination as to whether there is a dispute about fees, because if no fees are due the issue of the lien is moot."

The court distinguished between perfection and enforcement: "Perfection relates to the validity of a lien as between the lienholder and

another lienholder of a bona fide purchaser, whereas a lien can be enforced against the debtor who owns the subject property even if perfection was required but was not effected."

It disagreed with *Hoffman* on two grounds. First, it maintained that "[n]ot one New Jersey state court case ... holds that an attorney's lien under N.J.S.A. 2A:13-5 must be perfected to be valid as against third parties." It found also: "Neither does N.J.S.A. [§] 2A:13-5 or any other New Jersey statute or rule require that an attorney's lien must be perfected."

Second, it determined that in the jurisdictions to which the *Hoffman* court had referred for the proposition that an attorney's lien must be perfected, applicable state law explicitly requires perfection. Noting that "[i]t has been held that ... where state law does not specifically require perfection of an attorney's lien, it is valid against a bankruptcy trustee," the court concluded that "[this] rule applies in this case."

The court also invoked 11 U.S.C. 546(b). That subsection provides in relevant part that "the rights and powers of a trustee under sections 544, 545, and 549 of this title are subject to any generally applicable law that permits perfection of an interest in property to be effective against an entity that acquires rights in such property before the date of perfection."

The court observed that in states in which the effective date of an attorney's lien relates back to the commencement of the attorney's services, courts have held that §546(b) protects the attorney's lien from avoidance by the trustee. Recognizing that under New Jersey law an attorney's lien relates back to the

date on which it was created, the Bankruptcy Court concluded that "even assuming that perfection of an attorney's lien is required under New Jersey law, such lien is nevertheless valid against the trustee."

Accordingly, the court entered judgment determining that the firm's lien was valid. Shortly before this article went to press, the district court remanded the *Smith* decision back to the Bankruptcy Court.

Insofar as it has reason to believe that the amount of its fees will be at issue, counsel should, if possible, and as a precautionary measure, send a Pre-Action Notice and submit, during the pendency of the underlying proceeding in which it has acted, an application for a determination of the right to an attorney's lien under §2A:13-5. Such acts would satisfy not only the enforcement procedure under New Jersey case law but also the perfection requirement in *Hoffman*.

In the event it is too late to perform these acts, however, and the issue of perfection arises, the attorney seeking to impose the lien should argue, in accordance with *Smith*, that perfection is not required. Although it was recently remanded, the *Smith* decision may prove persuasive to other courts.

Meanwhile, the party opposing the imposition of an attorney's lien, such as a debtor or trustee in a bankruptcy case, should investigate whether the attorney sent a Pre-Action Notice and whether the attorney submitted during the course of the underlying action a §2A:13-5 application. If the attorney has failed to do either, the party should argue, in accordance with *Hoffman*, that the failure renders the attorney's lien

unperfected.

The party should also note that in *Martin*, the Appellate Division seemed to suggest that perfection is required, at least in instances in which more than one attorney has worked on a case. "[O]ne or more of the claiming attorneys should initiate an action for fees on notice to the client and all other attorneys claiming or potentially claiming rights to fee awards."

Further, inasmuch as the issue of perfection arises in the context of bankruptcy, the party opposing the lien may consider advancing two arguments not addressed in *Smith*. First, in *In re Mission Marine Assocs., Inc.*, 633 F.2d 678 (3d Cir. 1980), the Third U.S. Circuit Court of Appeals, applying the predecessor of §545(2), invalidated a non-possessory non-filing statutory lien on the basis of "New Jersey policy concerning the protection of bona fide purchasers against secret non-possessory liens." One can argue that an attorney's lien qualifies as a "non-possessory non-filing statutory lien," and, hence, that the lien may be avoided under §545(2).

Second, §545(2) is not limited to liens "not perfected." It also applies to liens not "enforceable." See §545(2) (providing in relevant part that "[a] trustee may avoid the fixing of a statutory lien on property of the debtor to the extent that such lien is not ... enforceable").

The *Smith* court found that the New Jersey rule requiring service of a pre-action notice "relates to enforcement." Thus, inasmuch as an attorney failed to file a Pre-Action Notice, one can argue that the failure renders the lien unenforceable and concomitantly, avoidable pursuant to §545(2). ■