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Monthly Analysis of Important Issues and Recent Developments in Bankruptcy Law

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THE DUTY OF NON-BANKRUPTCY ATTORNEYS TO MAKE REASONABLE INQUIRY OF A CLIENT'S BANKRUPTCY[1]

By Michael B. Joseph

INTRODUCTION

What duty does a non-bankruptcy attorney have to determine whether a client or a potential client is or has been a debtor in a bankruptcy case? The wrong answer to that question may prove disastrous to successful pursuit of claims on behalf of the client and threatens counsel with professional and financial exposure. A debtor's failure to disclose causes of action in a bankruptcy case has ramifications for the debtor, the debtor's attorney, and the non-bankruptcy attorney. This discussion will focus on the duties of non-bankruptcy attorneys to discover and manage a client's bankruptcy.[2]

Too often, non-bankruptcy attorneys do not inquire of a potential client whether they have any current or prior bankruptcy cases. Can an attorney safely rely on a client's response? Should the non-bankruptcy attorney take ad-

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[1]A version of this article first appeared in Considerchapter13.org, August 28, 2022.

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ditional steps to verify bankruptcy status? What is reasonable inquiry?

EXAMPLES OF RELEVANT NON-BANKRUPTCY CLAIMS

1. Unknown prepetition injury exists but has not manifested at time of bankruptcy filing.
2. Known prepetition injury claim or cause of action exists at time bankruptcy is filed but no action commenced.
3. At time of bankruptcy filing, injury claim or cause of action is in an administrative proceeding, arbitration or other nonjudicial process.
4. Prepetition injury lawsuit is pending at time bankruptcy case is filed.

DEBTOR'S INITIAL DISCLOSURE REQUIREMENTS

Debtors are required to provide full disclosure of prepetition injury claims or causes of action in the court documents that must be filed to commence and maintain a bankruptcy case under Fed. R. Bankr. P. 1007.

Bankruptcy Schedules A/B require disclosure of all claims in paragraphs 33 and 34:

> 33. Claims against third parties, whether or not you have filed a lawsuit or made a demand for payment. Examples: Accidents, employment disputes, insurance claims, or rights to sue. Describe each claim.
>
> 34. Other contingent and unliquidated claims of every nature, including counterclaims of the debtor and rights to set off claims. Describe each claim.

In the Statement of Financial Affairs (SOFA), paragraph 9, the debtor must disclose the following:

> Within 1 year before you filed for bankruptcy were you a party to any lawsuit, court action, or administrative proceeding? List all such matters, including personal injury cases, small claims action, divorces, collection suits, paternity actions, support or custody modifications and contract disputes.

To complete the answer to paragraph 9, the debtor must supply the status of any identified case, indicating whether it is "Pending, On Appeal, or Concluded."

The disclosure of claims and causes of action as part of a bankruptcy filing often requires listing matters in several places in the schedules and the SOFA. Failure to carefully do so may have serious consequences. For example, in *Edwards v.*

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CGI Group, Inc. (In re Ashmore),[3] when the debtor filed Chapter 7, he listed a Sarbanes-Oxley claim on the SOFA, but did not list it on Schedule B. The district court dismissed the cause of action based on judicial estoppel. The United States Court of Appeals for the Second Circuit reversed, rejecting the narrow approach taken by the district court and instead favorably viewing the debtor's claims of inadvertence and good faith in pursuing the lawsuit.

PROPERTY OF THE ESTATE

Under Bankruptcy Code § 541, the bankruptcy estate consists of all interests in property possessed by the debtor at the time of filing. Under § 1306, the Chapter 13 estate also includes property "that the debtor acquires after the commencement of the case but before the case is closed, dismissed, or converted to a case under chapter 7, 11, or 12 . . . , whichever occurs first. . . ." The nonexempt proceeds of property of the estate are also property of the estate under § 541(a)(6). Although not accurate in all circuits, it is often said that property of the estate in a Chapter 13 case includes all postpetition acquisitions and the appreciation in all prepetition assets "consistent with the ability-to-pay policy underlying Chapter 13."[4]

UNKNOWN PREPETITION INJURY

Examples of prepetition injury claims that may arise or become actionable after the filing of a bankruptcy include prepetition exposure to toxic or harmful substances, medical device failures, and other mass or class action tort claims.

Unknown prepetition claims are troublesome for plaintiff's attorneys. Obviously, an injured person cannot reveal an unknown injury. But as soon as the injury is known and counsel is consulted, a non-bankruptcy plaintiff's attorney should include bankruptcy questions in a client inquiry. If the attorney learns that a client has an injury and potential cause of action and is or has been a debtor in a bankruptcy case, the best practice for the attorney is to insist immediately that the client/debtor and bankruptcy counsel giving notice of the injury and potential action in the bankruptcy case(s)—without regard to the temporal relationship among the injury, the cause of action and the bankruptcy case(s), and without regard to the status of the bankruptcy case(s). The non-bankruptcy attorney should not presume to determine whether a bankruptcy court or trustee will ultimately consider the cause of action to be property of a bankruptcy estate. Bankruptcy courts and federal appellate courts do not agree on the rules for answering that question. But nondisclosure is universally an invitation to trouble for the client and for nonbankruptcy counsel. Reveal the injury and cause of action in the bankruptcy case(s) and then prepare, if necessary, to litigate whether the action belongs to the debtor individually, or to creditors through the bankruptcy estate.

CLAIMS AND CAUSES OF ACTION: ESTATE PROPERTY?

Numerous courts have addressed the question whether and to what extent a debtor's injury or cause of action becomes property of a bankruptcy estate.[5]

One long-standing protocol used by courts to identify whether claims are property of the bankruptcy estate is to inquire whether the elements of the claim are sufficiently "rooted" in the pre-petition past.[6] Related

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but not always aligned, is the "accrual approach" which looks to state law to determine when the claim accrued. Some courts apply a third approach which seems to blend the first two, focusing on when the claim or cause of action was discovered by the debtor.[7]

For example, in *In re Carroll*,[8] the debtor requested the district court to determine that product liability settlement proceeds from a transvaginal mesh patch implant, were not estate property. The debtor was entitled to a $240,000 settlement. Her bankruptcy case was filed in 2009 and a discharge was granted four months later in 2009. The transvaginal mesh device was implanted in 2003. The debtor alleged she did not know of any legal claim with respect to the device until 2014, some five years after her bankruptcy. The debtor eventually listed the lawsuit in the bankruptcy on an amended Schedule B. The debtor suffered serious medical problems and had additional medical procedures after the 2003 device implant. The court held that the debtor's lack of knowledge of the claim at the filing of her petition did not preclude the claim from being treated as property of the estate. The claim was sufficiently rooted in the prepetition past to be estate property.

In another transvaginal surgical mesh case, with a different result, the debtor filed Chapter 7 in November 2004. In 1998, the debtor had the device implanted, and in 1999 it was surgically removed. Upon learning in 2012 the device may have been defective, she engaged counsel. Thereafter the debtor was offered a settlement of $105,712.26. In 2015, personal injury counsel advised the Chapter 7 trustee of the settlement, inspiring the trustee to move to reopen the bankruptcy case to administer the proceeds. The debtor objected. Applying the "accrual approach," the bankruptcy court determined that the settlement proceeds were not property of the bankruptcy estate:

> If any element of the cause of action accrued post-petition, courts reason, the cause of action is not property of the estate, even if all of the *conduct* giving rise to the cause of action occurred pre-petition. Consider a personal injury claim based on an incident occurring pre-petition and on injuries manifesting themselves post-petition—such a claim is not property of the estate because the injury which is a requisite element of a personal injury cause of action, manifested itself only after the commencement of the bankruptcy case.[9]

On appeal, the district court affirmed, agreeing with the accrual approach:

> Although courts have not reached a uniform result in cases raising similar issues, a number of courts have reached results consistent with the one reached by this court. For example, in *Mendelsohn v. Ross*, 251 F. Supp. 3d 518, 526, 64 Bankr. Ct. Dec. (CRR) 32 (E.D. N.Y. 2017)[,] the Bankruptcy Court for the Western District of Pennsylvania applied a *Segal*-derived framework to proceeds a debtor might receive in a lawsuit related to a hip replacement that was filed pre-petition, dismissed without prejudice post-petition, and subsequently revived when she experienced an injury relating to the hip replacement. *Id.* The court there conducted an extensive analysis of § 541, *Segal*, and its progeny, and concluded that "[t]hrough *Segal*, the bankruptcy estate can retain value from claims that were predominately rooted in the debtor's prepetition history, but, as a matter of happenstance, did not fully accrue until after the petition date." *Id.* at 532.[10]

The district court "held, however, that 'it is not enough that a claim be 'rooted' in the pre-bankruptcy past. It must be 'sufficiently rooted.' "[11] The district court concluded the

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debtor's settlement stemmed from prepetition events, but the most critical element of the claim—the discovery of a defect in her device—did not occur until well after the petition date, and therefore her interest was not "sufficiently" rooted in her pre-bankruptcy past for purposes of § 541.

PREPETITION INJURY KNOWN AT TIME OF BANKRUPTCY

Full disclosure is required of debtors regardless whether formal action has commenced. Also required to be disclosed is whether the case is pending in court, or in an administrative action or arbitration. Every non-bankruptcy personal injury attorney should inquire at the initial client consultation whether the client has been the debtor in a bankruptcy case and the status of any such case, or whether the client is contemplating bankruptcy or has consulted bankruptcy counsel. At that time, it is a best practice to perform a PACER search about existing or past bankruptcies by the potential client.

In *Cannon-Stokes v. Potter*,[12] while pursuing a $300,000 employment claim against the United States Post Office, the plaintiff filed a Chapter 7 petition. In the petition, SOFA and schedules, the debtor declared she had no assets, claims or causes of action. The bankruptcy court granted a discharge. Thereafter the Post Office asserted that the employment claim was barred by judicial estoppel based on the debtor's failure to disclose in the bankruptcy case. The district court granted summary judgment on the merits and on appeal the Post Office renewed its judicial estoppel defense. The United States Court of Appeals for the Seventh Circuit held that the debtor was judicially estopped to maintain the employment action.

In an Eleventh Circuit case, even voluntary dismissal of the bankruptcy case did not prevent the imposition of judicial estoppel based on nondisclosure. The debtor attempted to defend the imposition of estoppel barring the pursuit of two lawsuits by first amending the schedules, and then by dismissing the bankruptcy case. The appellate court found that the debtor failed to disclose the claims in the initial bankruptcy filings and in any of six subsequent amendments to the schedules notwithstanding that the claims sought damages in excess of $14,000,000. The Eleventh Circuit affirmed dismissal of the lawsuits, rejecting the debtor's argument that voluntary dismissal of the bankruptcy case made dismissal of the suits an abuse of discretion.[13]

These cases illustrate that failure to respect the requirement of full disclosure of known injury claims in a bankruptcy case has game-ending consequences for the plaintiff/debtor. Non-bankruptcy counsel can protect the client from these consequences only by digging for information about prior, pending or contemplated bankruptcy cases and then insisting that complete disclosure be made by the debtor. The same bankruptcy disclosure is required whether the claim is in litigation, arbitration, mediation or some stage preliminary to more formal action. As soon as non-bankruptcy counsel learns of the existence of a client's bankruptcy, notice should be given. Should the debtor/client refuse to consent to giving notice, withdrawal from representation may be necessary.

DIFFERENCES BETWEEN CHAPTER 7 AND CHAPTER 13

Reasonable inquiry by non-bankruptcy counsel with respect to a client's bankruptcy

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includes discovering the existence of a bankruptcy case, and then determining the type and status of that bankruptcy case. There may be a different disclosure requirement depending on whether the client is or was a debtor in a Chapter 7 case, in contrast to a Chapter 13 case.

If the debtor/client is or was a Chapter 7 debtor, and the claim or cause of action arose entirely post-petition, there is no duty to disclose. However, if the claim or cause of action could be traced to a prepetition event or circumstance-is "sufficiently rooted" in prepetition events-even a Chapter 7 debtor must disclose the claim in the bankruptcy case. Failure to do so may forfeit recovery and a trustee, a creditor or the United States Trustee may challenge the Chapter 7 debtor's right to a discharge or request a revocation of discharge already entered. Under 11 U.S.C.A. § 727(d)(2) a revocation action can be brought up to one year after discharge or closing of the case. A challenge to discharge based on nondisclosure of a prepetition claim or cause of action is possible even if the bankruptcy case is closed at the time non-bankruptcy counsel learns of the problem.

In contrast, a personal injury claim that arises before or after the petition in a Chapter 13 case may be property of the Chapter 13 estate and may be subject to disclosure requirements in the Chapter 13 case, whether that case is still ongoing, discharged or closed.[14] This is a murky area of bankruptcy practice in which non-bankruptcy counsel should tread carefully, erring on the side of rapid, complete disclosure. Bankruptcy and appellate courts have struggled with the effects of confirmation of a Chapter 13 plan, vesting, and completion of plan payments on the content of the Chapter 13 estate.

11 U.S.C.A. § 1327(b) provides: "Except as otherwise provided in the plan or by the order confirming the plan, the confirmation of a plan vests all of the property of the estate in the debtor."

Although this provision seems reasonably clear, circuits are split on the application of the vesting effect of confirmation. Lundin, LundinOnChapter13.com, at § 120.3[6], observes: "Years of litigation in these and other contexts has produced a fruit salad of interpretations of the vesting effect in § 1327(b)."

For example, in *Barbosa v. Solomon*,[15] the United States Court of Appeals for the First Circuit held that the appreciated value of real estate would be considered estate property for the benefit of creditors even though the property vested in the debtor(s) at confirmation. The court was concerned about post confirmation acquisitions and windfalls. The Eleventh Circuit adopted *Barbosa* in *Waldron v. Brown*.[16] However, in *McDonald v. Burgie (In re Burgie)*,[17] the Bankruptcy Appellate Panel of the Ninth Circuit held that the post-petition appreciated value of property would not be considered disposable income that could be captured for unsecured creditors by a modified plan. The Ninth Circuit also considered the vesting effect of confirmation on property in *California Franchise Tax Board v. Kendall (In re Jones)*,[18] stating:

> The bankruptcy courts and other circuits have developed four approaches to harmonizing these sections and determining whether and to what extent property of the estate revests in the debtor at plan confirmation. Three of the approaches are based on the principle that property of the estate revests in the debtor upon plan confirmation, unless the plan provides otherwise. These approaches are known as

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> the modified estate preservation, estate transformation, and estate termination approaches. Under the modified estate preservation approach, estate property vests in the debtor upon plan confirmation, but property acquired after confirmation becomes property of the estate pursuant to § 1306(a). *See Barbosa*, 235 F.3d at 36-37. The estate transformation approach holds that § 1327(b) vests estate property in the debtor upon confirmation, retaining estate property only to the extent necessary to carry out the plan. *See Telfair v. First Union Mortg. Corp.*, 216 F.3d 1333, 1339-40 (11th Cir.2000); *Black v. U.S. Postal Serv. (In re Heath)*, 115 F.3d 521, 524 (7th Cir.1997). Finally, the estate termination approach, adopted by the bankruptcy court and the BAP in this case, holds that § 1327(b) revests all property of the estate in the debtor upon plan confirmation, and any property acquired after confirmation likewise vests in the debtor unless the plan or confirmation provides otherwise. *See In re Petruccelli*, 113 B.R. 5, 15 (Bankr.S.D.Cal.1990). Under any one of these approaches, estate property would have vested in Jones at plan confirmation, and that property would not have been subject to an automatic stay. *See* 11 U.S.C. §§ 362(a)(3), 362(a)(4).[19]

The court in *Jones* mentions and declines to adopt the fourth approach—the estate preservation approach—while stating that some property revests in the debtor and would be subject to the state's collection of taxes. The Ninth Circuit B.A.P followed up in a later case in which a Chapter 13 debtor was to receive post-petition stock options totaling $3.8 million. The court viewed the windfall as income, granting the trustee's request to modify the plan, consistent with *Jones*.[20]

FEE DISGORGEMENT AND OTHER SANCTIONS

Failure by a non-bankruptcy personal injury attorney to follow proper bankruptcy court procedures and rules can have dire consequences. This was made painfully clear in *In re McLemore*.[21] In this Chapter 13 case, the debtor scheduled a personal injury claim as an asset. The claim was accounted for in the confirmed plan with a provision to distribute any non-exempt proceeds to creditors. By the time bankruptcy counsel and the Chapter 13 trustee became aware that the debtor had (secretly) hired a personal injury law firm, the claim had been settled and funds disbursed to the debtor, but none to the estate or the Chapter 13 trustee. There was no evidence that the personal injury counsel knew of the bankruptcy.

Before the bankruptcy court were motions to appoint the personal injury counsel nunc pro tunc, to approve the settlement, and to approve attorney's fees and expenses for non-bankruptcy counsel. The debtor also moved to modify the plan, and the trustee moved to dismiss the case and to examine the debtor's transactions with non-bankruptcy counsel. The court pointed out that had personal injury counsel completed a PACER check before disbursing any settlement proceeds—or gone the further step of checking PACER at the outset of representation—timely action could have been taken and layers of problems avoided. The court held non-bankruptcy personal injury counsel directly responsible for any loss to the estate and creditors. The court declined to approve employment of the personal injury firm, denied approval of their fees and expenses, and ordered the firm to make the estate whole by paying the full settlement amount of $40,000 to the Chapter 13 trustee-including the portion disbursed to the debtor. The court held the debtor responsible for failing to communicate with each

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of his attorneys as to the status of his bankruptcy, and that the settlement proceeds had been pledged to creditors in his plan. Accordingly, further plan modification may be required.

In *Smith v. Meredith (In re Smith)*,[22] personal injury counsel was aware of the debtors' bankruptcy, but part of the accident claim was settled without bankruptcy court approval and without informing the Chapter 13 trustee. In *Smith*, husband and wife debtors (and their son) were involved in a post-petition auto accident. The non-bankruptcy personal injury attorney sought approval of employment and fees upon separate settlement of Mr. Smith's claim. Both motions were approved by the bankruptcy court. Over one year later, Mrs. Smith's claim was settled. Without seeking approval of employment or approval of the wife's settlement, the personal injury attorney disbursed the proceeds paying himself fees and expenses and paying the balance to the debtors.

Three years later, bankruptcy counsel for the Smiths filed a belated Application to Employ and a Motion to Approve the wife's settlement. The bankruptcy court described these matters as asking the court to:

> (1) approve the services of a lawyer whose work has already been done; (2) authorize the payment of fees to that lawyer when he has already been paid; (3) bless a personal injury settlement that has already been consummated; and (4) countenance the disbursement of net proceeds to the Debtors who have already received and spent that money, including a substantial amount of non-exempt proceeds.[23]

The court denied personal injury counsel's employment nunc pro tunc, disallowed his fees and expenses and ordered disgorgement for failure to comply with Bankruptcy Code § 329(a) and Bankruptcy Rule 2016(b). The court held that further proceedings would be necessary to determine any additional turnover under § 542(a) of the Bankruptcy Code.

McLemore and *Smith* evidence the harsh reality that non-bankruptcy counsel has responsibility to identify and manage the bankruptcies of personal injury clients and there are consequences for counsel for failure to take proper action in a debtor/client's bankruptcy case.

On the other hand, for an extreme example where the court denied a motion to dismiss by the trustee for bad faith in failing to disclose the existence of an auto accident, see in *In re Frank*.[24] The court there held that since plan payments were complete it was required to grant discharge notwithstanding nondisclosure—surely an unusual result and outlier in view of the debtor's conduct. It is not recommended that the non-bankruptcy attorney make these determinations. It is better to give notice of the claim to the trustee and all affected parties by making full disclosure in the Chapter 13 case.

CONCLUSION

Reasonable inquiry by a non-bankruptcy personal injury lawyer should include a PACER search of all potential clients and of all clients at the time settlement of a claim is contemplated. A PACER search will alert the lawyer to any current or past bankruptcy case. If one does appear, the lawyer should follow up with the client about the details and status of the case. These steps will help protect the client, the personal injury lawyer's engagement, and future administration of the claim. Especially in Chapter 13 cases, the non-bankruptcy at-

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torney should not attempt an independent determination whether a claim or cause of action is estate property. That inquiry is best left to the trustee, bankruptcy counsel and the bankruptcy court.

Of course, the plaintiff's attorney will need consent of the debtor/client to provide disclosure of the claim or cause of action in a prior or pending bankruptcy case. Should the client refuse or fail to cooperate, it may be necessary for counsel to withdraw from the action. To be sure, not a good outcome but better than the outcomes outlined above for failure to disclose.

ENDNOTES:

[2]For further review of the duties of disclosure imposed on debtors and their attorneys in bankruptcy cases see Donald Lassman, *A Debtor's Dilemma: Undisclosed Claims*, Am. Bankr. Inst. J. 14 (2018).

[3]*Edwards v. CGI Grp., Inc. (In re Ashmore)*, 923 F.3d 260 (2d Cir. 2019).

[4]*Waldron v. Brown (In re Waldron)*, 536 F.3d 1239, 1243 (11th Cir. 2008).

[5]*See* Walther & Killian, *Sufficiently Rooted Precedent and Policy*, 50 U. Mem. L. Rev. 287 (2019).

[6] See *Segal v. Rochelle*, 382 U.S. 375, 86 S. Ct. 511, 15 L. Ed. 2d 428 (1966).

[7]*See Mendelsohn v. Ross,* 251 F. Supp. 3d 518 (E.D.N.Y. 2017). *See also Sikirica v. Harber (In re Harber)*, 553 B.R. 522 (Bankr. W.D. Pa. 2016); Lassman, *A Debtor's Dilemma: Undisclosed Claims*, Am. Bankr. Inst. J. 14 (2018); Keith M. Lundin, LundinOnChapter13.com, § 46.11 ("Causes of Action Including Judicial Estoppel Issues"). *Wolfork v. Tackett*, 241 Ga. App. 633, 526 S.E.2d 436 (1999), *aff'd*, 273 Ga. 328, 540 S.E.2d 611 (2001) (disapproved of by, *Period Homes, Ltd. v. Wallick*, 275 Ga. 486, 569 S.E.2d 502 (2002)), is the seminal case that sent the insurance defense bar to raise judicial estoppel when debtors failed to list causes of action in their personal bankruptcies. Lundin states: "Although the holding in *Wolfork* is questionable, the message is clear. Don't take chances of nondisclosure of causes of action in chapter 13 cases."). Keith M. Lundin, LundinOnChapter13.com, § 46.11.

[8]*In re Carroll*, 586 B.R. 775, (Bankr. E.D. Cal. 2018).

[9]*In re Ross*, 548 B.R. 632, 638-39 (Bankr. E.D.N.Y. 2016), aff'd, 251 F. Supp. 3d 518, 64 Bankr. Ct. Dec. (CRR) 32 (E.D.N.Y. 2017).

[10]*Mendelsohn v. Ross*, 251 F. Supp. 3d 518, 526 (E.D.N.Y. 2017).

[11]*Mendelsohn v. Ross*, 251 F. Supp. 3d at 526.

[12]*Cannon-Stokes v. Potter*, 453 F.3d 446 (7th Cir. 2006).

[13]*Weakley v. Eagle Logistics*, 894 F.3d 1244, 65 Bankr. Ct. Dec. (CRR) 226 (11th Cir. 2018).

[14]*See* 11 U.S.C.A. § 1306.

[15]*Barbosa v. Solomon*, 235 F.3d 31 (1st Cir. 2000).

[16]*Waldron v. Brown*, 536 F.3d 1239 (11th Cir. 2008).

[17]*McDonald v. Burgie (In re Burgie)*, 239 B.R. 406 (B.A.P. 9th Cir. 1999).

[18]*California Franchise Tax Bd. v. Kendall (In re Jones)*, 657 F.3d 921 (9th Cir. 2011).

[19]*In re Jones*, 657 F.3d at 927-28.

[20]*See Berkley v. Burchard (In re Berkley)*, 613 B.R. 547 (B.A.P. 9th Cir. 2020).

[21]*In re McLemore*, No. 20-32131-WRS, 2022 WL 362915 (Bankr. M.D. Ala. 2022); *In re McLemore*, No. 20-32131-WRS, 2022 WL 618958 (Bankr. M.D. Ala. 2022).

[22]*Smith v. Meredith (In re Smith)*, 637 B.R. 758 (Bankr. S.D. Ga. 2022).

[23]*In re Smith*, 637 B.R. at 762.

[24]*In re Frank*, 638 B.R. 463 (Bankr. D. Colo. 2022).