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**Whether the Debtor or Bankruptcy Estate Owns Malpractice Claims That Accrue During  
a Chapter 11 Bankruptcy**

**Anna Chen, J.D. Candidate 2017**

Cite as: *Whether the Debtor or Bankruptcy Estate Owns Malpractice Claims That Accrue  
During a Chapter 11 Bankruptcy*

**Introduction**

While it is every debtor's hope that the bankruptcy attorney he or she hires is competent and qualified to practice bankruptcy, the possibility always exists that the hired attorney will commit legal malpractice. When an attorney commits such malpractice, the timing of the attorney's misconduct becomes crucial for purposes of determining who may institute a legal malpractice cause of action against the attorney—the debtor or the trustee of the estate.

When a debtor files for chapter 11 bankruptcy, three different time periods become important to determine whether the debtor or the estate holds certain rights and interests. The first time period is before a debtor files for bankruptcy. The second time period is after filing for bankruptcy<sup>1</sup> but before conversion. The third time period is post-conversion.<sup>2</sup>

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<sup>1</sup> See 11 U.S.C. § 541 (2014).

<sup>2</sup> See *id.* § 348.

If the misconduct that gives rise to the legal malpractice claim<sup>3</sup> occurs after the filing of a chapter 11 case but before the conversion to a chapter 7 case, the cause of action belongs to the bankruptcy estate. In that situation, the trustee, as the representative of the bankruptcy estate, becomes the real party in interest and is the only party with standing to bring the malpractice claims.<sup>4</sup> But if the legal malpractice occurs after the case has been converted to chapter 7, the cause of action belongs to the debtor.

The first two parts of this article discuss the statutory authority that governs this particular matter. Part I discusses section 541(a)(1) of title 11 of the United States Code (the “Bankruptcy Code”), which defines what is included in a bankruptcy estate’s “property.” Part II discusses section 1115(a)(1) of the Code, which expands the definition of “property” referenced in section 541. Part III examines recent cases in which courts held that causes of action that arose before conversion, including legal malpractice claims, ultimately belonged to a bankruptcy estate. Part IV concludes by examining the implications of this rule for practicing bankruptcy attorneys as well the rights of debtors and bankruptcy estates.

## **I. Section 541(a)(1): Property of the Bankruptcy Estate**

### **A. The Bankruptcy Estate Includes a Broad Scope of Property**

The filing of a petition for reorganization under chapter 11 of the Bankruptcy Code creates an estate.<sup>5</sup> Section 541 of the Code then determines what that estate is comprised of.

(a) The commencement of a case . . . creates an estate. Such estate is comprised of all of the following property, wherever located and by whomever held:

(1) . . . all legal or equitable interests of the debtor in property as of the commencement of the case.<sup>6</sup>

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<sup>3</sup> See *State Farm Life Ins. Co. v. Swift*, 129 F.3d 792, 795 (1997) (“[S]ome form of legal injury must occur before these causes of action accrue.”).

<sup>4</sup> See 11 U.S.C. § 323.

<sup>5</sup> See *Louisiana World Exposition v. Fed. Ins. Co.*, 858 F.2d 233, 245 (5th Cir. 1988).

<sup>6</sup> 11 U.S.C. § 541(a)(1).

Much like the Supreme Court’s broad interpretation of property,<sup>7</sup> other courts’ broad interpretation of the phrase “legal or equitable interests” in section 541(a)(1) is consistent with the legislative history.<sup>8</sup>

This broad scope of “legal and equitable interests” encompasses a variety of different property interests. All interests of the debtor in personal property as of the commencement of the case, wherever located and by whomever held, become property of the estate.<sup>9</sup> Such rights include, *inter alia*: property held by debtor as bailee or agent; property covered by a security interest<sup>10</sup>; personal services contracts; licenses; stock exchange seats or memberships,<sup>11</sup> business social media accounts,<sup>12</sup> and the goodwill of a business.<sup>13</sup>

B. Causes of Action Also Included as Part of “all legal and equitable interests”

The reference to “all legal and equitable interests” includes any causes of action belonging to the debtor at the time the case is commenced.<sup>14</sup> For example, upon filing a bankruptcy petition, a debtor’s personal injury claim that arose before the filing of the petition becomes property of the estate.<sup>15</sup> In *Cohen v. Arlington (In re Engelbrecht)*, the debtor filed for

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<sup>7</sup> See *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 204–05 (1983) (“Both the congressional goal of encouraging reorganizations and Congress’ choice of methods to protect secured creditors suggest that Congress intended a broad range of property to be included in the estate.”).

<sup>8</sup> See H. R. REP. NO. 95–595, at 367 (1977) (“The scope of [section 541(a)(1)] is broad. It includes all kinds of property, including tangible or intangible property, causes of action . . . and all other forms of property currently specified in section 70a of the Bankruptcy Act.”).

<sup>9</sup> See COLLIER ON BANKRUPTCY, ¶ 541.05 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2009), available at LEXIS 5-541 Collier on Bankruptcy P 541.05. Real property rights and interests are also included in the estate and comprise one of the largest classes of property that may become part of the debtor’s estate. See *id.* ¶ 541.04. Such rights include, *inter alia*: life estates; equity or right of redemption; leases and contracts for the sale of land; rights of the debtor as a holder of a lien; dower and curtesy; joint tenancies; tenancy by the entirety; and tenancy in common. *Id.*

<sup>10</sup> See *id.* ¶ 541.05.

<sup>11</sup> See *id.* ¶ 541.06.

<sup>12</sup> See *In re CTLI, LLC*, 2015 Bankr. LEXIS 1117 (Bankr. S.D. Tex. Apr. 3, 2015).

<sup>13</sup> See *In re Prince*, 85 F.3d 314, 324 (7th Cir. 1996).

<sup>14</sup> See *Louisiana World Exposition v. Fed. Ins. Co.*, 858 F.2d 233, 245 (5th Cir. 1988).

<sup>15</sup> See *Cohen v. Arlington (In re Engelbrecht)*, 368 B.R. 898 (Bankr. M.D. Fla. 2007).

bankruptcy after accruing outstanding medical bills deriving from a car accident.<sup>16</sup> The debtor failed to list on her schedule a potential claim against the truck company that was responsible for the accident.<sup>17</sup> Later, the debtor filed a post-petition personal injury action against the company in state court.<sup>18</sup> The trustee learned of this personal injury action, reopened the bankruptcy proceeding, and the debtor amended her schedules to reflect her pre-petition claim.<sup>19</sup> The sole question before the bankruptcy court was whether the trustee may be substituted as the proper party-plaintiff to pursue the personal injury claim.<sup>20</sup> According to the court, only a trustee has standing to pursue a personal injury cause of action that arose pre-petition.<sup>21</sup>

Importantly, the trustee who asserts a cause of action on behalf of the estate generally stands in the debtor's shoes regarding defenses to the action.<sup>22</sup> Therefore, most defenses, legal or equitable, which could have been asserted against the debtor may be asserted against the trustee. Likewise, any defenses that the debtor could have asserted may be asserted by the trustee against claims.

*i. The Estate Even Succeeds to Causes of Action About Which the Debtor Was Not Aware*

Property of the estate can even include causes of action about which the debtor was not aware prior to the bankruptcy petition.<sup>23</sup>

In *Wheeler v. Magdovitz (In re Wheeler)*, the debtor hired an attorney to represent him in filing a chapter 7 bankruptcy in the Bankruptcy Court for the Northern District of Mississippi.<sup>24</sup>

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<sup>16</sup> *Id.* at 899–900.

<sup>17</sup> *Id.* at 900.

<sup>18</sup> *Id.*

<sup>19</sup> *Id.* at 900–01.

<sup>20</sup> *Id.* at 902.

<sup>21</sup> *Id.*

<sup>22</sup> See COLLIER ON BANKRUPTCY, ¶ 541.07 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2009), available at LEXIS, 5-541 Collier on Bankruptcy P 541.07.

<sup>23</sup> See *id.*; see also *Wheeler v. Magdovitz (In re Wheeler)*, 137 F.3d 299 (5th Cir. 1998).

The petition, prepared by the attorney, indicated that the bankruptcy estate contained no assets.<sup>25</sup> The debtor received a discharge.<sup>26</sup> Five years later, the debtor was indicted and convicted of falsifying and concealing assets that should have been included in the bankruptcy estate.<sup>27</sup> The debtor then filed a malpractice action against the bankruptcy attorney, arguing that his criminal conviction arose from the attorney's negligent handling of his bankruptcy action.<sup>28</sup> The Fifth Circuit Court of Appeals affirmed the order of the bankruptcy court finding that the bankruptcy estate, not the debtor, exclusively owned the malpractice claim.<sup>29</sup> The Fifth Circuit reasoned that the malpractice claim arose pre-petition because the debtor had ample opportunity to discover the discrepancies between his actual assets and those listed on the bankruptcy petition at the time he signed the petition.<sup>30</sup>

Outside of personal injury and legal malpractice claims, courts have also determined that an estate can institute actions against the government;<sup>31</sup> actions to enforce rights pursuant to a contract;<sup>32</sup> and actions to recover damages for misconduct, mismanagement, or neglect of duty by a corporate officer or director.<sup>33</sup>

## **II. Section 1115(a)(1): Expansion of the Definition of “property” under Section 541(a)(1)**

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<sup>24</sup> 137 F.3d at 300.

<sup>25</sup> *Id.*

<sup>26</sup> *Id.*

<sup>27</sup> *Id.*

<sup>28</sup> *Id.*

<sup>29</sup> *Id.* at 301.

<sup>30</sup> *Id.*

<sup>31</sup> *See* Wyoming Dep't of Transp. v. Straight (*In re* Straight), 143 F.3d 1387 (10th Cir. 1998).

<sup>32</sup> *See* Scotchel v. Sheehan, No. 1:13-CV-161, 2014 U.S. Dist. LEXIS 26614 (N.D.W. Va. Mar. 3, 2014).

<sup>33</sup> *See In re* Citizens Corp., No. 311-11792, 2012 Bankr. LEXIS 4232 (Bankr. M.D. Tenn. Sept. 11, 2012).

Section 1115 of the Bankruptcy Code was amended in 2005 to include an individual chapter 11 debtor's post-petition earnings and property acquisitions in the bankruptcy estate.

Section 1115 provides, in relevant part, that:

(a) In a case in which the debtor is an individual, property of the estate includes, in addition to the property specified in section 541—

(1) all property of the kind specified in section 541 that the debtor acquires after the commencement of the case but before the case is closed, dismissed, or converted to a cause under chapter 7, 12, or 13, whichever occurs first<sup>34</sup>

A. Property Acquired Post-petition Belongs to the Estate

Section 1115(a)(1) provides that property of the estate will also include proceeds, product, rents, and profits of such property identified under section 541.<sup>35</sup> This includes rent paid with respect to pre-petition property and post-petition interest paid on pre-petition investments.<sup>36</sup>

B. The Estate is Entitled to the Entire Portion of the Awards Recovered from a Cause of Action

In the personal injury context, awards of claims belonging to the estate belong entirely to the estate. Courts have rejected debtors' requests to bifurcate recovery for pain and suffering into pre-petition and post-petition events. That is, where a trustee is successful in obtaining an award for the estate, courts have rejected debtors' arguments that the debtors should be entitled to a post-petition apportionment of that recovery.<sup>37</sup>

In *Wischan v. Adler*, in a consolidated appeal of two bankruptcy court orders, both debtors suffered injuries from tortious conduct. Both filed lawsuits shortly after, seeking

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<sup>34</sup> 11 U.S.C. § 1115(a)(1).

<sup>35</sup> See COLLIER ON BANKRUPTCY, ¶ 1115.02 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2009), available at LEXIS, 7-1115 Collier on Bankruptcy P 1115.02.

<sup>36</sup> *Id.*

<sup>37</sup> See *Wischan v. Adler (In re Wischan)*, 77 F.3d 875, 876 (5th Cir. 1996).

compensation for injuries.<sup>38</sup> Both also shortly thereafter filed for chapter 7 bankruptcy.<sup>39</sup> In one case, the court entered an order allowing the trustee to enter into a settlement.<sup>40</sup> In the other case, the debtor was awarded a monetary judgment but the court ordered the debtor to pay the trustee the proceeds of his judgment.<sup>41</sup> In both cases, the debtors filed adversary proceedings claiming that the proceeds should be apportioned into pre-petition and post-petition compensation.<sup>42</sup> The debtors argued that they were entitled to the post-petition apportionment of the judgment. The Fifth Circuit Court of Appeals rejected the debtors' arguments, reasoning "[t]he fact that the cause of action may have borne fruit in settlement or judgment after commencement of the bankruptcy case does not transform them into post-petition property of the debtor that—excluded from the bankruptcy estate—any more than post-petition payments on a pre-petition note owed to the debtor would be excluded from the estate."<sup>43</sup>

### III. Recent Cases Applying Sections 541(a)(1) and 1115(a)(1)

Several courts recently have interpreted sections 541(a)(1) and 1115(a)(1) to additionally mean that causes of action that belong to the debtor at the time the case is commenced or that are acquired after commencement but before conversion<sup>44</sup> are therefore property belonging to the estate.<sup>45</sup>

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<sup>38</sup> *Id.*

<sup>39</sup> *Id.*

<sup>40</sup> *Id.*

<sup>41</sup> *Id.*

<sup>42</sup> *Id.* at 876–77.

<sup>43</sup> *Id.* at 877.

<sup>44</sup> Section 348 of the Bankruptcy Code governs the effect of conversion of a case under one chapter of the Bankruptcy Code to another chapter. It provides, in general, that conversion of a case constitutes a new order for relief under the chapter to which the case is converted. *See* 11 U.S.C. § 348. Rule 1019 of the Federal Rules of Bankruptcy Procedure implements section 348. *See* Fed. R. Bankr. P. 1019.

<sup>45</sup> *See Cantu v. Schmidt (In re Cantu)*, 784 F.3d 253, 257 (5th Cir. 2015); *see also Depumpo v. Thrasher*, No. 05-14-00967-CV, 2016 WL 147294 (Tex. App. Jan. 13, 2016).



In *Depumpo v. Thrasher*, a debtor asserted a cause of action seeking declaration that a final judgment and settlement in two prior lawsuits prevented an attorney from pursuing any action against him.<sup>46</sup> The debtor contended that he had standing to assert the claim because the cause of action arose after the commencement of the bankruptcy case and was therefore not property of the estate.<sup>47</sup> The court, however, found that the debtor lacked standing to pursue this cause of action because a trustee had already been appointed, and the debtor's claim was acquired after the commencement of his bankruptcy case but prior to conversion to chapter 7.<sup>48</sup> Thus, the trustee had exclusive standing to bring the claim.<sup>49</sup>

In *Cantu v. Schmidt (In re Cantu)*, the Fifth Circuit Court of Appeals held that legal malpractice claims that arose after the filing of the petition but prior to conversion to chapter 7 belonged to the bankruptcy estate.<sup>50</sup> After filing a voluntary chapter 11 petition in the Bankruptcy Court for the Southern District of Texas in May of 2008, the debtors hired an attorney one month later to represent them.<sup>51</sup> In December of 2008, a number of creditors later moved to convert the bankruptcy to one under chapter 7 due to the decreasing value of the debtors' assets.<sup>52</sup> The bankruptcy court granted the motion and a trustee was appointed. The bankruptcy court determined that the debtors should not be allowed to discharge their debts due to a number of omissions, misrepresentations, and controversies that plagued the bankruptcy.<sup>53</sup> A few years later, the debtors hired another attorney to investigate a possible legal malpractice

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<sup>46</sup> 2016 WL 147294, at \*2.

<sup>47</sup> *Id.* at \*4.

<sup>48</sup> *Id.*

<sup>49</sup> *Id.*

<sup>50</sup> 784 F.3d at 257.

<sup>51</sup> *Id.* at 255.

<sup>52</sup> *Id.* at 256.

<sup>53</sup> *Id.*

claim against the first attorney.<sup>54</sup> Upon learning of this, the trustee informed the new counsel that he believed any legal malpractice claims were property of the estate under the trustee's sole authority to prosecute.<sup>55</sup> The bankruptcy court agreed and permitted the trustee to investigate the legal malpractice claim.<sup>56</sup> The trustee later filed a legal malpractice claim against the first attorney in state court.<sup>57</sup> After removal to district court, the parties settled.<sup>58</sup>

The district court in the malpractice action referred the case to the bankruptcy court to determine whether the settlement proceeds belonged to the debtors or to the bankruptcy estate.<sup>59</sup> On this particular issue, the parties agreed that the attorney's malpractice in handling the bankruptcy occurred before the conversion to chapter 7.<sup>60</sup> The debtors, however, argued that the necessary injury occurred only after conversion when their assets were liquidated and the bankruptcy court denied them discharge.<sup>61</sup> Therefore, they argued the cause of action belonged to them. The trustee, on the other hand, argued that the estate itself suffered injuries from the attorney's malpractice and that those injuries arose earlier, prior to conversion.<sup>62</sup> Thus, the action belonged to the estate.

The bankruptcy court ultimately agreed with the trustee, and the Fifth Circuit Court of Appeals confirmed. The Fifth Circuit concluded that the attorney's misconduct injured the creditors in several ways during the pendency of the chapter 11 bankruptcy such that the estate could have filed the lawsuit prior to conversion.<sup>63</sup> The Fifth Circuit noted that the attorney's

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<sup>54</sup> *Id.* at 256–57.

<sup>55</sup> *Id.* at 257.

<sup>56</sup> *Id.*

<sup>57</sup> *Id.*

<sup>58</sup> *Id.*

<sup>59</sup> *Id.*

<sup>60</sup> *Id.* at 260.

<sup>61</sup> *Id.*

<sup>62</sup> *Id.*

<sup>63</sup> *Id.* at 261.

actions caused the depletion of assets that could have otherwise gone to creditors.<sup>64</sup> The attorney also submitted a non-confirmable plan, which harmed the estate because it ultimately led to liquidation, which is disfavored over a reorganization.<sup>65</sup> Furthermore, the delay and cost resulting from the more than twelve month effort to submit a plan of reorganization harmed the estate.<sup>66</sup> Citing the widespread misconduct that injured the estate prior to conversion, the Fifth Circuit ultimately held that the cause of action against the attorney accrued prior to conversion and belonged to the estate.<sup>67</sup>

#### **IV. Conclusion**

Section 541 of the Bankruptcy Code provides that once a debtor files a chapter 11 petition, any and all causes of action that he or she could have instituted now belong to the estate; only the trustee may bring those actions. Section 1115 goes further to provide that any cause of actions that arose after chapter 11 but prior to chapter 7 conversion also belong to the estate. *In re Cantu* examined these statutes in the context of a legal malpractice claim. The court there concluded that because the legal malpractice occurred during the chapter 11 case and ended up depleting the assets of the estate and led to liquidation as opposed to a confirmed plan of reorganization, only the estate could file the legal malpractice cause of action.

The timing of the legal malpractice claims will largely control whether a debtor or a trustee can pursue such claims. While no party ever hopes that the hired attorney mishandles the

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<sup>64</sup> *Id.*

<sup>65</sup> See *Canadian Pac. Forest Prods. Ltd. v. J.D. Irving, Ltd. (In re Gibson Grp., Inc.)*, 66 F.3d 1436, 1442 (6th Cir. 1995) (explaining that the purpose of chapter 11 is to allow debtors the opportunity to reorganize, “and thereby to provide creditors with going-concern value rather than the possibility of a more meager satisfaction through liquidation”).

<sup>66</sup> See Elizabeth Warren & Jay L. Westbrook, *The Success of Chapter 11: A Challenge to the Critics*, 107 MICH. L. REV. 603, 625 (2009) (“[F]ees and other expenses associated with a Chapter 11 case diminish the value available to creditors, a consequence that is felt most sharply if the reorganization fails and liquidation follows. In addition, the time spent in bankruptcy itself leads to the loss of value.”).

<sup>67</sup> *In re Cantu*, 784 F.3d at 263.

bankruptcy in a way that injures the value of the estate, the possibility exists. Once a chapter 11 case is filed, the bulk of rights and interests, including the right to bring a cause of action for legal malpractice, belong to the estate. But if the malpractice occurred after conversion to chapter 7, the malpractice claim belongs to the debtor.