The Potential Cost – to You and Your Client - of
Failing to Disclose a Tort Claim in a Chapter 7 Bankruptcy in the First Circuit

I. Introduction – The Call

During a break in a mediation a few weeks ago, I noticed my Inbox was full of messages with subject lines such as "Urgent!" "Help Needed!" "Call me!" A scroll through my Call Log uncovered that the same attorney was responsible for several voicemails. Immediately, I knew that his determination to speak with me meant one thing - the dreaded topic of "bankruptcy" had emerged in one of his cases.

The attorney had good reason to panic. His call was prompted by defense counsel's mediation argument that because the plaintiff had filed bankruptcy post-accident and had failed to list her personal injury claim as an asset, she was barred from recovery. As discussed below, this argument had merit and more importantly, it reminded me that as plaintiff's counsel we need to keep tabs not only on the defendant's bankruptcy status, but our own client's status as well.[1]

II. Managing the Issue - Preventative Maintenance and Bankruptcy Fundamentals

Preventative maintenance is the first step in avoiding a defendant's motion to dismiss based on nondisclosure in bankruptcy. Financial distress is a topic that is often addressed in the initial consultation as our clients have typically suffered bodily or financial injuries that have caused resulting loss of income, substantial medical bills or other financial problems. Also, in the current economy, our clients are facing non-accident related financial stress at an alarming rate. Even in personal injury cases, finances should be discussed with the potential client and the tort lawyer should ask whether the potential client has filed bankruptcy or is contemplating filing bankruptcy. Furthermore, the attorney can easily check the bankruptcy filing status of a potential client at *pacer.psc.uscourts.gov*.

A companion discussion between the bankruptcy attorney and the same client must occur regarding the claim. Disclose, disclose, disclose. Significant, substantial, worthless…Disclose! Appreciation of this bankruptcy principle must be emphasized to bankruptcy clients at the initial bankruptcy consultation. Additionally, potential causes of action, no matter how remote, causes of action should be explored with clients. Simply asking "Do you have a right to sue someone?" is not enough. Consumer clients in particular will answer "No" to the former question, yet during the consultation a potential cause of action is discovered that was not obvious to the client. Unfortunately, some clients understand that disclosure may cause the loss of all or some of the asset for the benefit of creditors and knowingly fail to disclose the asset (in which case one should run from the case as quickly as possible). In either scenario, nondisclosure could have potentially fatal consequences to the tort case and your efforts to prepare the case for trial and/or settlement.

If the potential client is in bankruptcy, or needs to file bankruptcy midstream, the case may still have value to the client and to you. The first step is to contact the bankruptcy attorney to notify him/her that you are pursuing the claim if the bankruptcy has not been filed, or ask if

the claim was disclosed if the bankruptcy case has already been filed. If the claim was disclosed, you will want to know whether the client claimed all or a portion of it as exempt.[2] If the claim was not disclosed, you will need to discuss (actually insist!) amending the schedules immediately.

After gathering the background information on the bankruptcy, the next critical step is to contact the trustee to start the process of retention as Special Counsel for the bankruptcy estate or, in the alternative, abandonment of the claim by the trustee which returns the rights in the claim to the plaintiff/debtor.[3] Court appointment is a pre-condition to your receiving payment for fees and costs.[4] Although being cooperative with the trustee is in the best interest of you and your client, and standard practice, you should keep in mind attorney-client privilege when communicating with the trustee. At this stage, no attorney-client relationship exists with the trustee and the trustee may ultimately abandon the claim. Therefore, your assessment of the claim, strategies, work product, etc. may be discoverable information.

Thus, the threshold issue for you, the plaintiff/debtor and the trustee is whether the trustee is interested in pursing the claim. As mentioned above, the plaintiff/debtor may claim that a portion or all of a personal claim as exempt. If the exemption is allowed, the plaintiff/debtor is entitled to keep that exempted portion of the claim, free and clear of any claims by creditors or rights/interests of the trustee. Whether the claim is abandoned depends on several factors such as the likelihood of success, the value of the claim, the amount of allowed exemptions, the amount of creditors' claims, etc. Generally speaking, if there will be almost nothing to pay to creditors out of any settlement in a case after payment of attorneys' fees, the plaintiff/debtor's exemptions and other administrative costs, the trustee will likely abandon the claim.

If the trustee decides not to abandon the claim, you must file your application for retention as Special Counsel pursuant to 11 U.S.C. § 327.[5], [6] The application must include an affidavit or certification stating that you do not hold or represent any interest adverse to the trustee or the estate. Also, you must disclose past or present dealings with the debtor, any family member, business associate or creditor of the debtor. Although local bankruptcy rules allow for retention of professionals on an *ex parte* basis, the risk is that compensation will be objected to in the future. Therefore, it is recommended that plaintiff's counsel file the application to employ and notice it for hearing.

Upon receipt of the order approving your application, you may move forward with pursuing the claim. When the claim has resolved and funds are available for distribution, the bankruptcy court must approve your fees and costs. The debtor is then paid the exempt portion of the claim, administrative costs, including trustee's fees, are paid and finally the remaining funds are distributed to creditors.

But what happens when a debtor, either through fraud or inadvertence, fails to disclose an asset such as a tort claim? Does the plaintiff/debtor have any hope of benefiting from the asset? What does plaintiff's counsel do? Has all of their work been wasted? Can the defendant escape liability because of the plaintiff/debtor's fraud or mistake? Is the asset, which should have been liquidated for creditors, lost? What about the principles of justice?

III. Tension – Competing Interests

Nondisclosure battles typically arise when the claim is not disclosed on the debtor's schedules, the discharge order is entered and then the debtor subsequently proceeds to initiate (or continue) his/her tort claim. The defendant(s) in the tort case then moves to dismiss arguing judicial estoppel and/or lack of standing.

At first blush, the decision on whether to strictly apply judicial estoppel to bar a plaintiff/debtor's nondisclosed tort claim may seem simple – the claim should be barred as the plaintiff/debtor submitted a false oath to the bankruptcy court that no such asset existed. However, as several courts have discussed, whose interest does such a hard line benefit? Should the court apply judicial estoppel to punish the plaintiff/debtor at the expense of other parties, such as creditors, who then suffer the consequences of the debtor's actions? Consider the competing parties' arguments.

> *Trustee:* One of the primary duties of a trustee is to "collect and reduce to money the property of the estate for which such trustee serves, and close such estate as expeditiously as is compatible with the best interests of the parties in interest."[7] When a nondisclosed claim is discovered after the case has been discharged, the trustee should have the opportunity to investigate the asset as if it had been disclosed and decide whether to pursue the same. Similarly, trustees are paid a set fee to administer a case and a percentage of the assets liquidated to pay creditors. Therefore, a nondisclosed claim also has a direct impact on the trustee's compensation.
>
> *Creditors:* In the eyes of creditors, the claim was already lost at the initial filing stage to their detriment and to the debtor's benefit. Barring the claim punishes the debtor's (alleged) fraud, but also punishes creditors by taking money out their pocket for a second time. As the Seventh Circuit summarized:
>
>> [The debtor's] nondisclosure in bankruptcy harmed his creditors by hiding assets from them. Using this same nondisclosure to wipe out [the debtor's claim against the defendant] would complete the job by denying creditors even the right to seek some share of the recovery. Yet the creditors have not contradicted themselves in court. They were not aware of what [the debtor] has been doing behind their backs. Creditors gypped by [the debtor's] maneuver are hurt a second time by the district judge's decision. Judicial estoppel is an equitable doctrine, and using it to land another blow on the victims of bankruptcy fraud is not an equitable application.[8]

Of course the court is also in the difficult position of having a party before it who may have committed fraud on the court warranting sanctions which cause a loss to other parties-in-interest.

IV. A Two Front Attack: Judicial Estoppel and Standing

Nondisclosure cases usually involve a two pronged attack on the continuation of the plaintiff/debtor's claim -- judicial estoppel and standing. Either analysis could be the end of the

road for the plaintiff/debtor; however, other parties' interests may still be served by the decision reached by the court.

Judicial estoppel is an equitable doctrine which is applied to prevent "abuse of the judicial process, resulting in an affront to the integrity of the courts."[9] The Supreme Court has articulated guidelines on whether to apply the equitable doctrine, including (1) whether a party's later position is "clearly inconsistent" with its earlier position; (2) whether a party succeeded in persuading a court to accept the earlier position; and (3) "whether the party seeking to assert an inconsistent position would derive an unfair advantage or impose an unfair detriment on the opposing party if not estopped."[10] However, the Court left the door open for other factors to be applied stating that "[i]n enumerating these factors, we do not establish inflexible prerequisites or an exhaustive formula for determining the applicability of judicial estoppel."[11] Indeed, the First Circuit considers an additional factor, focusing on the intent of the debtor and looking for evidence of a debtor's bad faith in the nondisclosure.

The seminal case formulating the framework for the "intent" analysis in the First Circuit is *Payless Wholesale Distributors, Inc. v. Albert Culver (P.R.) Inc.*[12] Payless Wholesale Distributors, Inc. ("Payless") filed Chapter 11 bankruptcy in July 1988.[13] The schedules filed by Payless did not refer to potential claims against defendants, yet in July 1990, Payless filed a 110 page complaint with 20 causes of action alleging pre-bankruptcy unlawful business transactions by the defendants.[14] "Even a cursory examination of the claims shows that defendants should have figured in both aspects of the Chapter 11 proceedings, and that Payless could not have thought otherwise. The brazenness of its ambivalence is illustrated by its present assertion that the statute of limitations had not run because it had been tolled by the pendency of Chapter 11."[15]

In a very sharp opinion, the court unambiguously established that debtors who do not disclose potential claims may lose them. "Payless, having obtained judicial relief on the representation that no claims existed, can not now resurrect them and obtain relief on the opposite basis. This may not be strictly equitable estoppel, as the court observed. Indeed, defendants may have a windfall. However, it is an unacceptable abuse of judicial proceedings."[16] After noting the importance of full disclosure in bankruptcy proceedings in order to protect the court and creditors, the court, in affirmance, rebuked the district court's statement that Payless' filings were not intentionally inconsistent.[17] The court left little doubt as to whether motive/intent was a factor in its decision, stating "Assuming there is validity in Payless's present suit, it has a better plan. Conceal your claims; get rid of your creditors on the cheap, and start over with a bundle of rights. This is a palpable fraud that the court will not tolerate, even passively."[18]

The following year, the court expanded upon its judicial estoppel analysis and introduced the standing analysis. The Chapter 7 debtor in *Brooks v. Beatty, et. al.* failed to schedule a claim for fraud and negligence against defendants on her bankruptcy schedules.[19] The defendant moved for dismissal under judicial estoppel which was initially denied but was subsequently granted on reconsideration in light of *Payless*.[20]

A significant difference between *Brooks* and *Payless* was the plaintiff/debtor's defense to the nondisclosure. The plaintiff/debtor in *Brooks* argued that the lower court's application of

Payless was too broad and rigid and should not apply to her because she had not engaged in "willful or iniquitous conduct" but was instead negligent.[21] The court emphasized that *Payless* did not move judicial estoppel away from its "traditional moorings" and that it "is an equitable device which does not lend itself to reflexive application."[22] Because the debtor had produced evidence that she was twice advised by her bankruptcy counsel that she was not required to schedule the claim against defendants, summary judgment was inappropriate.[23]

However, the court went on to find that the plaintiff/debtor lacked standing to prosecute the claim because the claim was not scheduled and therefore was never abandoned by the trustee.[24] Therefore, the case was remanded so that the bankruptcy case could be reopened to give the bankruptcy trustee the opportunity to sell or abandon the claim, or to intervene in the pending action.[25] If the claim was returned to the plaintiff/debtor, the court indicated that the district court should hold an evidentiary hearing on the judicial estoppel issue. Alternatively, in the event that the claim was transferred to another entity or retained by the trustee, the court indicated that the case should proceed on the merits.[26]

For the third time in as many years, the nondisclosure issue was again addressed by the First Circuit in *Jeffrey v. Desmond.*[27] The plaintiffs/debtors failed to disclose their claim against defendant, Brooks Drug, Inc. ("Brooks") in their Chapter 7 bankruptcy case. On the eve of trial, Brooks discovered the omission and moved for dismissal on the grounds of judicial estoppel. Rather than completely dismissing the case, the bankruptcy case was reopened on motion of the trustee's motion to administer the undisclosed asset for the benefit of creditors. The case was settled for $10,000, subject to court approval. The debtors challenged the settlement as inadequate.

Although the court quickly disposed of the primary issue at hand – whether approval of the compromise was proper – it seized upon two of the debtors' arguments to further instruct on the issue of the application of judicial estoppel to nondisclosure cases. The arguments focused on the debtors' claim that they and their attorney disclosed the claims to the trustee during the § 341 creditors' meeting and the trustee determined that the case had no value.[28] The debtors argued that the disclosure evidenced a lack of fraud and the trustee's inaction after the disclosure amounted to abandonment of the asset.[29] The court did not find the oral disclosure argument persuasive, stating "…whether or not appellants' initial failure to schedule the state court asset was intentional, the glaring fact remains that, but for the investigation made by counsel for [Brooks], appellants' failure to list on the schedule the state court action at any time during the bankruptcy proceedings would never have come to the attention of the state court, the bankruptcy court, or the Trustee. As we have already noted, appellants' 'silence' here is thoroughly 'defeaning'."[30]

Thereafter, the issue was addressed by several district courts in the First Circuit but no reported decisions in New Hampshire were issued until *Locapo v. Colsia* in April 2009.[31] The (*pro se*) plaintiff/debtor in *Locapo* claimed that the defendants made misrepresentations, engaged in unfair and deceptive acts and practices and committed other wrongs in the course of a real estate transaction between the parties.[32] These claims were not listed on the debtor's/plaintiff's bankruptcy schedules or his amended schedules.[33] After receiving his discharge, debtor/plaintiff filed a claim in district court against the defendants.[34]

The New Hampshire District Court focused on the standing issue which was argued as the basis for dismissal by the defendant rather then judicial estoppel. Even so, the court perhaps overstated the division between the judicial estoppel and standing analysis as an "either/or" choice – "Courts sometimes enforce this prohibition [failing to disclose a cause of action and then bringing an action post-bankruptcy] through the doctrine of judicial estoppel…But others, including the court of appeals for this circuit, have relied on the operation of § 521 in conjunction with another provision of the bankruptcy code, § 554, which provides for abandonment of the property of the bankruptcy estate."[35] Instead, this author views the early decisions of the First Circuit as focused on the judicial estoppel/bad faith argument equally, if not more, than the standing issue. Nevertheless, the court agreed with the defendant's argument/position that the standing analysis alone was sufficient to grant dismissal of the case as plaintiff/debtor had clearly failed to schedule the claim and therefore, pursuant to 11 U.S.C. § 521(1) and § 554(c) and (d) the claim remained property of the estate which was not abandoned by the trustee. Like the other decisions discussed herein, the court left the door open for the case to continue, suggesting a "potential solution" as reopening the bankruptcy case to schedule the claims and allowing the trustee to evaluate the claims. Of course, if the claims were abandoned by the trustee, the plaintiff/debtor would still be subject to a judicial estoppel defense and given the precedent and the factual background discussed in the opinion would face a steep uphill battle.[36]

V. The Call Revisited

At my first opportunity I contacted my colleague who had been frantically seeking bankruptcy advice from his mediation. By that point, the fire had been extinguished as the defendant apparently backed down and the claim was settled. He and his client were fortunate.

When the nondisclosure is discovered "late in the game" and the trustee is noticed of the claim, the same process applies wherein plaintiff's counsel should, to the extent possible, cooperate with the trustee in the evaluation of the benefit of the claim to the estate in the hope that the trustee will retain you as Special Counsel. There is always the risk that the trustee will substitute new counsel and the plaintiff's attorney is left only with applicable lien rights. Generally speaking, this author has found that trustees recognize the benefit of continuing with the original attorney and will continue with existing plaintiff's counsel. In addition, the plaintiff/debtor's cooperation and interest is likely going to influence the value of the claim and therefore trustees are generally willing to negotiate a deal to keep the plaintiff/debtor's interest. However, the possibility looms that the trustee may abandon the claim and the debtor loses the judicial estoppel argument, extinguishing the claim and forcing you to write-off the case in the loss column.

VI. Conclusion

An undisclosed tort claim in bankruptcy can cause significant problems for a plaintiff/debtor seeking to liquidate the asset and the plaintiff's attorney preparing the case and (most likely) advancing expenses. Ideally, counsel learns of the bankruptcy before it is filed and works with the bankruptcy attorney and trustee from the beginning. Even if the case has been

filed and the claim not disclosed, amendments may still be made to correct the nondisclosure error if the case is still pending. However, the discovery of the nondisclosed claim after the bankruptcy case has been closed creates a series of hurdles which may reach an undesirable and costly result. When in doubt, walk down the hall to a bankruptcy colleague or give me a quick call to discuss how big (or small) of a problem bankruptcy could cause your client's tort case.

---

[1] This article will discuss the First Circuit's analysis of nondisclosure of tort claims in bankruptcy filings. The analysis discussed herein may vary in other jurisdictions. Furthermore, the discussion is limited to Chapter 7 bankruptcy cases.

[2] Debtors are allowed to exempt certain property from the estate, including tort claims to a capped value. In New Hampshire, debtors may choose between state and federal exemptions with the federal exemptions providing a larger benefit for this particular asset. *Compare* 11 U.S.C. § 522(d)(5), (10) and (11); RSA 511:2(XVII) (the "wildcard exemption").

[3] Property is abandoned in several ways. First, the trustee may investigate the claim and decide the it burdensome or of inconsequential value to the estate and therefore is voluntarily abandoned. *See* 11 U.S.C. § 554(a). Also, a party in interest may petition the court to order the trustee to abandon property which is burdensome or of inconsequential value. *See* 11 U.S.C. § 554(b). Lastly, assets which are scheduled but not administered by the trustee are abandoned to the debtor when the case is closed. *See* 11 U.S.C. § 554(c). *See also* 5 COLLIER ON BANKRUPTCY § 554.02[3].

[4] The statutes on recovery of attorneys' fees can result in a harsh and seeming unfair outcome. For example, in *Xifaras v. Morad*, 328 B.R. 264 (1st Cir B.A.P. 2005) a creditor sought approval as an administrative expense attorneys' fees and costs she incurred in pursuit of a fraudulent transfer claim against the debtor pre-petition and a change in venue of the bankruptcy case. The creditors efforts resulted in three properties which had been conveyed to family members becoming property of the bankruptcy estate. Although the court acknowledged the creditors' efforts benefited the estate, no statutory provision allowed for payment of the attorneys' fees and costs and the denial of the fees and costs was affirmed.

[5] Any expert witnesses you may need must also be approved by the court.

[6] *See also* Bankruptcy Rule 2014 and Local Bankruptcy Rule2014-1.

[7] 11 U.S.C. § 704(a)(1).

[8] *Biesek v. Soo Line R.R. Co.*, 440 F.3d 410, 413 (7th Cir. 2006).

[9] *Pike v. Mullikin*, 965 A.2d 987, 990 (2009), *citing* 31 C.J.S. *Estoppel and Waiver* § 188 (2008).

[10] *New Hampshire v. Maine*, 532 U.S. 742, 750-51 (2001) (citations omitted).

[11] *Id.* at 751.

[12] 989 F.2d 570 (1st Cir. 1993).

[13] *Id.* at 571.

[14] *Id.*

[15] *Id.*

[16] *Id.*

[17] *Id.*

[18] *Id.*

[19] 25 F.3d 1037 (1994) at *2.

[20] *Id.* at *1.

[21] *Id.* at *2.

[22] *Id.* at *3.

[23] *Id.*

[24] *Id.*

[25] *Id.*

[26] *Id.*

[27] 70 F.3d 183 (1st Cir. 1995).

[28] *Id.* at 186.

[29] *Id.*

[30] *Id.* at 187.

[31] 2009 WL 1083924, ---F.Supp.2d--- (D.N.H. April 22, 2009); *See e.g.*, *Graupner v. Town of Brookfield*, 450 F.Supp. 119 (D. Mass. 2006); *GE HFS Holdings, Inc. v. National Union Fire Ins. Co. of Pittsburgh, PA*, 2008 WL 2246673 (D. Mass. May 29, 2008).
[32] *Id.* at *1.
[33] *Id.* at *2.
[34] *Id.*
[35] *Id. at *3, citing Jefffrey*, 70 F.3d at 186 (other citations omitted).