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Appellate Courts Split On Bankruptcy Ownership Of Malpractice Claims

By Michael L. Cook

The debtors' legal malpractice claim was "not property of their bankruptcy estate," held a split Ninth Circuit on June 30, 2020. *In re Glaser*, 816 Fed. Appx. 103, 104 (9th Cir. June 30, 2020) (2-1). But the U.S. District Court for the District of Minnesota one week later affirmed a bankruptcy court judgment that "the [debtor's] estate was the proper owner" of such a claim. *In re Bruess*, 2020 WL3642324, 1 (D. Minn. July 6, 2020). Most recently, the Sixth Circuit held that the debtors' malpractice claim was their property "and not the bankruptcy estate." *In re Blasingame*, 2021 WL 245300, 1 (6th Cir. Jan. 26, 2021).

All three courts relied on state law in their decisions, purportedly consistent with U.S. Supreme Court precedent. *Rodriguez v. FDIC*, 589 U.S. ___, 140 S. Ct. 713 (Feb. 25, 2020) (state law determines a "fight over [ownership of] a tax refund."). As shown below, however, federal law should have governed ownership of the claims in all three cases, making them available to creditors as assets of the bankruptcy estate. Judicial hair-splitting, when applying state law to federal bankruptcy cases, creates only uncertainty, but Article I, section 8, of the U.S. Constitution mandates "uniform" bankruptcy law.

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Relevance

The ownership of malpractice claims is significant in business cases. If the claims are part of the debtor's estate, creditors share in any recovery. When the claims are excluded from the estate, though, creditors receive nothing. As the Sixth Circuit noted in Blasingame, "[t]here is little agreement both inter- and intra-circuit, on how courts should deal … with a claim for legal malpractice against the filing attorneys …." *Blasingame*, 2021 WL 245300, at 5.

State law may determine the existence of a claim "as of the commencement of the case" under Bankruptcy Code §541(a)(1), but a court should "carefully distinguish between state-law principles for determining when 'accrual has occurred for purposes of ownership in a bankruptcy [case],'" and "principle(s) of discovery and tolling," as the dissent in *Glaser* stressed. *Glaser*, 816 Fed. Appx. at 106, quoting *Cusano v. Klein*, 246 F.3d 936, 947 (9th Cir. 2001). *See also, Chartschlaa v. Nationwide Mut. Ins. Co.*, 538 F.3d 116, 123 (2d Cir. 2008) (property "deeply rooted in the pre-bankruptcy past … should be considered part of the bankruptcy estate."); *In re Shearin*, 224 F.3d 346, 351 (4th Cir. 2000) ("Pre-petition assets … rooted" in debtor's pre-petition activities "belong to the estate and ultimately to the creditors."). Ownership "is what counts for purposes of Code §541(a)(1)," which defines the bankruptcy estate. But all three courts here limited their focus to Code §541(a), ignoring another relevant Code section, §101(5)(A).

The Code's Definition Of 'Claim'

Code §101(5)(A) broadly defines "claim" to mean "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured …." According to the relevant legislative history, "this broadest possible definition [of "claim"] … no matter how remote or contingent, will be able to be dealt with in the … case … [and] permits the broadest possible relief in the bankruptcy court." H.R. Rep. No. 95-595, at 309 (1977). Because Congress

did not limit the definition to claims *against* the debtor, claims by the debtor should also be included in the broad definition. Creditors can thus share in any recovery on those claims.

Courts have been divided in the past on when a claim *against* a debtor arises in bankruptcy cases. *See*, *e.g.*, *Grady v. A.H. Robins Co*, 839 F.2d 198, 199 (4th Cir. 1988) (claim arose pre-bankruptcy, based on debtor's conduct); *In re Piper Aircraft Corp.*, 58 F.3d 1573, 1576 (11th Cir. 1995) (pre-petition relationship test); and *In re ZiLOG, INC.*, 450 F.3d 996, 999-1000 (9th Cir. 2006) ("fair contemplation" that a claim exists). Regardless of the label, though, courts generally agreed on some pre-bankruptcy conduct giving rise to the claim, even if the harm is manifested after bankruptcy. *In re Grossman's Inc.*, 607 F.3d 114, 125 (3d Cir. 2010) (*en banc*). That same analysis should apply to a debtor's asserted tort claim such as malpractice.

Glaser, Bruess and Blasingame: Facts

1. *Glaser*. The debtors in *Glaser* hired counsel prior to bankruptcy who allegedly filed their bankruptcy petitions "too early," causing the debtors to lose the benefit of a bankruptcy discharge. *Glaser*, 816 Fed. Appx., at 105-106 ("Had Debtors' counsel filed their bankruptcy petition six days later than she did, Debtors would have been able to discharge more than a quarter-million dollars in tax debt to the IRS."). Income tax claims for which a return is due within three years of the bankruptcy petition are generally not dischargeable, Code §§523(a)(1)(A) and 507(a)(8)(A)(i), but the debtors, on their counsel's advice, filed their petition within a week of the three-year boundary, allowing the tax claims to survive her bankruptcy.

2. *Bruess*. The debtor in *Bruess* similarly alleged that her counsel had negligently advised her. If she filed a bankruptcy petition, advised the lawyer, her recently acquired homestead property would be exempt under Code §522(a)(3)(A). When the bankruptcy court denied the exemption, she sued her lawyer for malpractice.

3. *Blasingame*. The debtors claimed that they lost their bankruptcy discharge because their lawyers negligently "failed to properly investigate and draft [their] schedules and statement of financial affairs," prior to their bankruptcy filing. 2021 WL 245300, at 3. But they argued that the denial of their discharge, was "a post-petition event," so as to keep any recovery for themselves. *Id.*

Issues

Role of State Law

All three courts here purported to rely on state law to determine when the debtors' claims arose. In *Glaser*, the Ninth Circuit reasoned that "a claim for legal malpractice does not accrue until damage has been sustained" and that "damages … happened after the bankruptcy case commenced." *Glaser*, 2020 WL 3536532, at 1. In *Bruess*, though, the reviewing district court held that the debtor sustained damage when she reached the "point of no return" on the filing of her bankruptcy petition under applicable Minnesota law. *Bruess*, 2020 WL 3642324, at 2-3. "[A]lthough the damage was not necessarily measurable until later in the [case]," reasoned the court in *Bruess*, "the malpractice claim … belongs to the bankruptcy estate and not to [the debtor]". *Id.* at 3. In *Blasingame*, the Sixth Circuit held that the malpractice claim did not arise under Tennessee law "until after the [post-bankruptcy] judgment denying the … discharge was entered" because the debtors "were unaware" of the lawyers' alleged malpractice. 2021 WL245300, at 6.

The three courts' blinkered reliance on state law ignores the statutory and judicial context of a federal bankruptcy case, in particular the Code itself. According to the Supreme Court, "[s]tatutory construction … is a holistic endeavor. A provision that may seem ambiguous in isolation is often clarified by the remainder of the statutory scheme — because the same terminology is used elsewhere in a context that makes its meaning clear …, or because only one of the permissible meanings produces a substantive effect that is compatible with the rest of the law." *United Savings Association of Texas v. Timbers of Inwood Forest Associates, Ltd.*, 484 U.S. 365, 371 (1988).

Analysis: Time of Injury Governs

Code's Broad Definition Of Claim.

All three courts here failed to address the Code's broad definition of "claim." They chose instead to wrestle over interpretations of state law. But a "'claim' can exist under the Code before a right to payment exists under state law." *Grossman's*, 607 F.3d at 121. As the smart dissent in *Glaser* stressed, a court should focus on ownership, not on "principles of discovery and tolling, which

may cause the statute of limitations to run after accrual has occurred …." *Glaser*, 816 Fed. Appx., at 106. *See, Cusano v. Klein*, 264 F.3d 936, 947 (9th Cir. 2001) (debtor's "open book account claim accrued for bankruptcy purposes to the extent that sums were owed on that account at the time he filed his [bankruptcy] petition. An action could have been brought for these sums at that time [although] limitations on such an action had not yet begun to run."). *See also, In re Swift*, 129 F.3d 792, 798 (5th Cir. 1997) (in determining when claims accrued "for ownership purposes in a bankruptcy [case] … [t]ime of discovery of the injury is not relevant …. A cause of action can accrue for ownership purposes before the statute of limitations for that [claim] has begun to run …. [F]ocus … upon the moment the injury occurred.").

As the *Glaser* dissent noted, "the Debtors' too-early filing of the [bankruptcy] petition *immediately* placed Debtors in a prejudicial position that counts as damage under Nevada law," giving rise "to a right to sue for malpractice" for property purposes "as of the commencement of the bankruptcy case" under Code §541(a)(1). *Glaser*, 816 Fed. Appx. at 106-07. In fact, the lawyers allegedly gave bad advice to the debtors well before they filed their petitions in *Glaser*, *Bruess* and *Blasingame*. "[A]t the moment the [Glasers'] counsel filed the bankruptcy petition, they were placed in a prejudicial position that would require attorney intervention." *Glaser*, 816 Fed. Appx. at 106-07. The lawyer's error "constitutes cognizable damage that provides a complete cause of action …." *Id*. at 107.

Precedent Governs

The Third Circuit held in *Grossman's* that "a 'claim' arises when an individual is exposed [prior to bankruptcy] to … conduct giving rise to an injury, which underlies a 'right to payment' under the … Code." 607 F.3d at 125, citing Code §101(5), after reviewing prior case law. *See*, *e.g.*, *Grady v. A.H. Robins*, 839 F.2d 198, 199 (4th Cir. 1988) (plaintiff injured by product prior to bankruptcy, but detected injury after bankruptcy; *held*, plaintiff held a contingent claim that arose before bankruptcy).

The seminal decision is *Segal v. Rochelle*, 382 U.S. 315 (1966), a preCode U.S Supreme Court case whose reasoning still applies here. The Court held there that a debtor's tax refund claims made after bankruptcy were "sufficiently rooted in the prebankruptcy past" so that they constituted property of the debtor's estate as of "the date the bankruptcy petitions were filed." *Id.* at 379-80, cited in the *Glaser* dissent. 816 Fed. App., at 107. *Accord*, *In re Ryerson*, 737 F.2d 1423, 1926 (9th Cir. 1984) ("The Code follows *Segal* insofar as it includes afteracquired property 'sufficiently rooted in the prebankruptcy past.'"). *Contra*, *In re Bracewell,* 454 F.3d 1234; 1242 (11th Cir. 2006) ("*Segal* told us how to define property under the old bankruptcy [Act] before it was amended in 1978 to include an explicit definition of property"; rejected *Segal*'s "sufficiently rooted" test). *See also, Dewsnup v. Timm*, 502 U.S. 410, 419 (1992) ("When Congress amends the bankruptcy law, it does not write 'on a clean slate.' … Furthermore, this Court has been reluctant to accept arguments that would interpret the Code, however vague the particular language under consideration might be, to effect a major change in pre-Code practice that is not the subject of at least some discussion in the legislative history.").

State law, of course, determines whether a malpractice claim exists. But the issue here is ownership of the claim. In sum, the debtors' alleged injuries in *Glaser*, *Bruess* and *Blasingame* were fixed under federal bankruptcy law before they filed their bankruptcy petitions. Federal bankruptcy law, Code §§101(5)(A) and (541)(a)(1), determined ownership of the claim, but state law will apply to resolving the merits of the claim.

Comment

Creditors have a real interest in persuading the U.S. Supreme Court to resolve the Circuit split here. If decisions like *Glaser* and *Blasingame* remain the law, creditors will be the losers.

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