When Debtors Forget to Schedule P.I. Suits

A debtor can lose standing to litigate

By Craig D. Robins

There is one question that Chapter 7 trustees like to ask debtors twice at the meeting of creditors: "Are you currently suing anyone or do you have the right to sue anyone?"

The reason trustees like to ask this question twice is because many debtors forget to tell their attorneys that they have a cause of action, which can be a valuable asset worth administering.

Causes of action are considered assets that must be disclosed in the bankruptcy petition. Because of their unusual nature (they're intangible, unliquidated and contingent), many consumer debtors just don't think about them like they would a more typical asset like a car or bank account. Consequently, many debtors don't tell their bankruptcy attorneys about them even when asked.

A debtor who neglects to list such an asset can end up in a heap of trouble – sometimes losing the possibility of exempting the asset or seeking recovery, or in extreme cases, losing the ability to obtain a discharge.

Judge Alan S. Trust, sitting in the Central Islip Bankruptcy Court, issued a decision a few years ago in which he denied a debtor's application to re-open a case to pursue a P.I. cause of action. In this month's column I will discuss non-disclosed causes of action which can be a P.I. case or any other right to sue.

Bankruptcy Code provides for Duty of Disclosure

The debtor's obligation to disclose a cause of action is based on Code Section 521(a) which requires a debtor to schedule "contingent and unliquidated claims of every nature" and provide an estimated value of each one.

The trustee has the ability to step into the debtor's shoes and pursue any litigation claims the debtor has. It is therefore essential that the debtor disclose all contingent and unliquidated claims so that the trustee can make a determination of whether to pursue those claims for the benefit of the debtor's estate. *In re: Costello*, 255 B.R. 110 (Bankr. E.D.N.Y. 2000).

When a debtor inadvertently omits a cause of action or pending suit from the schedules, and the trustee catches this at the meeting of creditors, the resolution is usually simple. The trustee directs debtor's counsel to amend the schedules and the trustee investigates the viability of pursuing the cause of action.

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However, resolving a non-disclosed cause of action becomes much trickier once the case is closed, and that has a lot to do with the concept of standing.

Issues with Re-Opening a Case

Here's the typical scenario: Debtor had a cause of action stemming from injuries suffered in an accident. However, the debtor neglected to tell his or her bankruptcy attorney about it. Then, for whatever reason, when questioned by the trustee about the right to sue anyone, the debtor testified that he or she did not have the right to sue anyone. The case then was routinely closed and the debtor received a discharge.

Then, a year or two passes during which time the debtor's personal injury attorney brings suit and is about to settle the case. However, defense counsel advises P.I. counsel that they did a bankruptcy search and discovered that the plaintiff filed for bankruptcy relief but failed to schedule the cause of action for the accident. They tell the surprised P.I. attorney, "Sorry, there's no longer any settlement money on the table because your client lacks standing as a plaintiff in the P.I. case!"

That's because even after a bankruptcy case is closed, non-disclosed causes of action and litigation remain the property of the bankruptcy estate, unless abandoned by the trustee. Case law provides that if the trustee never knew about the potential estate property, the trustee could not have abandoned it.

Thus, even though the bankruptcy case was closed, the cause of action is still the sole property of the trustee, and the debtor lacks standing to commence or continue the suit. Upon learning of this, P.I. counsel will invariably make a frantic call to debtor's former bankruptcy counsel.

So what can bankruptcy counsel do in this situation after getting the frantic call? Nationally, there are two schools of thought – estopping the trustee and estopping the debtor. In the Fifth, Seventh, Tenth, and Eleventh Circuits, the Courts have found that the trustee should not be estopped from commencing or continuing a suit, as the trustee is the real party in interest.

These courts, however, punish the debtor, who they say should be estopped so that any excess proceeds, instead of going to the debtor, instead go back to the defendant. The reasoning here is to protect the integrity of the bankruptcy process while preserving assets of the estate for distribution to creditors. Doing so deters dishonest debtors who fail to disclose assets, while at the same time, protecting the rights of creditors.

However, there does not seem to be any appellate authority in the Second Circuit. My personal experience with these situations is that the court will permit trustees to reopen a case to administer a non-disclosed asset in most situations, provided that there is no egregious evidence of bad faith on the part of the debtor.

Keep in mind that if the asset was not disclosed, then the debtor did not avail him or herself of any applicable exemption, such as the personal injury exemption, now a minimum of $7,500. If debtor's counsel were to try to re-open the case and amend the schedule of exemptions, the trustee would likely object. The best case scenario may be to negotiate a disposition with the trustee in which the debtor gets half the exemption.

In one case before Judge Trust, the debtor sought to re-open the case to amend schedules to include a non-disclosed P.I suit against the Long Island Rail Road. Even though the debtor had already retained separate P.I. counsel prior to the bankruptcy, the debtor did not tell his bankruptcy attorney about it and did not truthfully answer the trustee's questions about pending lawsuits.

The District Court, where the P.I. case was pending, permitted the suit to be dismissed upon learning of the prior bankruptcy filing, stating that the debtor lacked standing. When the debtor sought to re-open the bankruptcy case to get standing, Judge Trust refused to permit the debtor to do so, citing the debtor's lack of good faith.

In the March 2010 opinion, Judge Trust, using colorful football terminology, stated that debtor's motion to re-open appeared to be "an effort to make an end run around the District Court's dismissal order." *In re: Carlos Meneses* (05-86811-ast, Bankr.E.D.N.Y.).

The practical tip here is to question your client and question again about possible causes of action or potential claims. Also, if you later discover an omitted asset, amend your schedules immediately.

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