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Bankruptcy Court Retained Jurisdiction Over Sale of Legal Malpractice Cause of Action

May 22, 2013

Lawyers for the Profession® Alert

In re: Stokes: Duncan v. Stokes, 2013 WL 492477 (Bkrcty. D. Mont. 2013)

Brief Summary

The U.S. Bankruptcy Court for the District of Montana maintained jurisdiction over an adversary proceeding in which plaintiffs filed a petition for declaratory judgment to determine that defendant's state law legal malpractice claim against his bankruptcy attorney was the estate's property and that the bankruptcy court had jurisdiction to enforce its order. The order approved the sale of the estate's interest in the legal malpractice cause of action to the attorney who initially filed for relief under Chapter 11 of the Bankruptcy Code on behalf of defendant, after the attorney outbid defendant. Despite defendant's bid to the trustee for the cause of action, he moved to dismiss arguing that jurisdiction was lacking because the cause of action did not accrue until after the bankruptcy was converted to Chapter 7, and therefore was not part of the bankruptcy estate. The court held that the adversary proceeding was a core proceeding, despite the fact that the legal malpractice claim was not and did not fall within the court's "related to" jurisdiction. Thus, the bankruptcy court had jurisdiction over the declaratory judgment action.

Complete Summary

Plaintiffs' former client retained them to file a voluntary petition for relief under Chapter 11. A few months later, plaintiffs withdrew from the representation. The U.S. Trustee then moved to convert the case to a Chapter 7 proceeding. Two years later, defendant filed a legal malpractice case in state court seeking monetary damages. The trustee intervened and obtained a stay of the state court suit to allow the bankruptcy court to determine whether the suit qualified as property of the estate. The bankruptcy court issued an order allowing the trustee to auction the estate's interest in the legal malpractice claim for the purpose of maximizing the value of the estate. After the trustee filed a notice of intent to sell, and received no objection, the bankruptcy court entered an order authorizing the trustee to sell the estate's interest in the state law claim. The trustee sold the bankruptcy estate's interest in the malpractice action to one of the plaintiff attorneys and filed a report of sale with the bankruptcy court.

After the sale, plaintiffs moved for summary judgment, seeking declaratory relief and contending that the state law legal malpractice claim arose in the

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bankruptcy case and was a core proceeding within the bankruptcy court's jurisdiction. Plaintiffs contended that the legal malpractice claim was the bankruptcy estate's property before and after conversion to Chapter 7. They sought a declaration that defendant's state law claim was barred by the claim preclusive effect of the bankruptcy court's order approving the sale.

Defendant moved to dismiss for lack of subject matter jurisdiction, arguing that the state law claim did not come into existence, and he did not sustain damages until after his bankruptcy case was converted to Chapter 7. He also contended that the bankruptcy court lost jurisdiction to determine whether the state law claim was the estate's property once the claim was sold. Plaintiffs argued that the state law claim was at all times the estate's property, and that defendant should be barred by judicial estoppel from opposing jurisdiction because he had submitted a bid to the trustee to purchase the estate's interest in the claim, thereby acknowledging the court's jurisdiction.

The bankruptcy court determined that defendant failed to demonstrate a genuine issue of material fact. According to Section 541 of the Bankruptcy Code, the bankruptcy estate's property included "all legal or equitable interests of the debtor in property as of the commencement of the case." Defendant's state court complaint alleged that plaintiffs rendered improper advice and that they improperly prepared and filed his schedules. Because many of the claims arose before the filing of defendant's Chapter 11 petition, the legal malpractice claims were the estate's property pursuant to Section 541. The court noted that defendant's bid to purchase the claim from the trustee demonstrated his belief that the claim was the estate's property. The bankruptcy court found that the legal malpractice claim was neither a core proceeding nor within the court's "related to" jurisdiction because the outcome of that claim could not alter the debtor's rights or impact the handling or administration of the estate.

However, plaintiff's petition for declaratory judgment was within the bankruptcy court's "related to" jurisdiction because plaintiffs' purchase of the estate's interest in the legal malpractice claim invoked a substantive right created by federal bankruptcy law, and could not exist outside of bankruptcy in the state court. The outcome could alter or have an affect on the bankruptcy estate. Pursuant to Ninth Circuit precedent in *In re Goodman*, 991 F.2d 613, 617 (1993), the petition for declaratory judgment involved enforcement of the bankruptcy court's order approving the sale of the estate's state law claim. Thus, the bankruptcy court granted plaintiffs' motion, holding that the petition for declaratory judgment was a core proceeding because it involved a determination regarding the nature and extent of the bankruptcy estate which was a fundamental function of the bankruptcy court. The court therefore had jurisdiction over the adversary proceeding and could enforce its order approving the sale of the estate's interest in the legal malpractice claim.

Significance of Opinion

This case demonstrates that a bankruptcy court maintains jurisdiction over proceedings to determine whether a legal malpractice claim is property of the estate, even though the cause of action itself is not a core proceeding or within the "related to" jurisdiction of the bankruptcy court. The focus is on whether the proceeding involves the nature and extent of the bankruptcy estate or affects the administration of the estate.

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