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In re Cantu: Timing Can Be Everything in Bankruptcy

Marco and Roxanne Cantu filed for chapter 11 relief, along with their wholly owned corporation, Mar-Rox Inc., after facing foreclosure on a number of their real estate holdings.¹ At the time of the bankruptcy filing, the Cantus, individually and through Mar-Rox, owned approximately \$24.4 million in real estate.² The Cantus also had more than \$37.4 million in secured debt and more than \$10.7 million in unsecured debt. Mar-Rox's secured debt exceeded \$20.9 million.³

The debtors hired Ellen Stone and Stone Law Firm PC to represent them in their jointly administered complex chapter 11 cases.⁴ Stone represented the Cantus and Mar-Rox for 13 months, during which time she incurred \$202,915.06 in legal fees and expenses, all of which were ultimately approved by the bankruptcy court.⁵

Seven months into the chapter 11 cases, a number of creditors moved to convert the cases to chapter 7, and the bankruptcy court granted the motion to convert on the basis that the reorganization plan submitted by the debtors was not confirmable.⁶ Following the conversion to chapter 7, the chapter 7 trustee sought to have the Cantus' discharge denied. In its lengthy decision denying the Cantus' discharge, the bankruptcy court detailed numerous "omissions, misstatements, and controversies" that plagued the Cantu and Mar-Rox bankruptcies.⁷

The Cantus subsequently hired new counsel to investigate potential malpractice claims against Stone and her law firm.⁸ The trustee then put new counsel on notice that he believed the malpractice claims were property of the estate and within his sole discretion to pursue.⁹ A lawsuit was ultimately commenced by the Cantus and their new counsel

against Stone and her firm in state court, asserting various claims arising from alleged misconduct that occurred prior to the case's conversion from chapter 11 to chapter 7. The Cantus sought fee forfeiture and reimbursement; Stone had the case removed to federal district court, where it survived a motion to remand, and the parties ultimately settled the action for \$281,710.54.¹⁰ The district court referred the case to the bankruptcy court to determine whether the settlement proceeds were property of the bankruptcy estate or should go to the Cantus.¹¹

Timing Is Everything When It Comes to Property of the Estate

Section 541 of the Bankruptcy Code provides that property of the estate includes "all legal or equitable interest of the debtor in property as of the commencement of the case."¹² Section 1115(a)(1) provides an expansive definition of "property of the estate" for individual chapter 11 debtors, which includes "all property of the kind specified in section 541 that the debtor acquires after the commencement of the case but before the case is ... converted to ... Chapter 7."¹³ Thus, if the causes of action against Stone and her firm were acquired at or after the time of conversion of the Cantus' chapter 11 case, the settlement proceeds would not be estate property and thus would belong to the Cantus. However, if the causes of action were acquired after the filing of the chapter 11 petition but before conversion to chapter 7, the proceeds would properly be part of the bankruptcy estate.

On appeal, the Fifth Circuit determined that the accrual approach is the proper standard for determining when a malpractice cause of action arises.¹⁴ The court relied on its prior decision in *In re Swift*,¹⁵ as well as similar decisions from other circuits that fol-



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1 *Cantu v. Schmidt (In re Cantu)*, 784 F.3d 253, 255 (5th Cir. 2015).
2 *Schmidt v. Cantu (In re Cantu)*, Ch. 7 Case No. 08-70260, Adv. No. 09-7018, 2011 WL 672336, at *1 (Bankr. S.D. Tex. Feb. 17, 2011).
3 *Id.* These debts were incurred to finance the debtors' businesses and lavish lifestyles.
4 *Cantu v. Stone (In re Cantu)*, Ch. 7 Case No. 08-70260, Adv. No. 13-07001, 2013 WL 2253201, at *1 (Bankr. S.D. Tex. May 22, 2013).
5 *Cantu*, 784 F.3d at 256.
6 *Id.*
7 *Id.* (quoting *Cantu*, 2011 WL 672336, at *2). In the 38-page decision, the bankruptcy court highlighted the Cantus' failure to disclose significant assets, including \$134,575 in jewelry sales, two contingency fee cases held by Mr. Cantu, and two life-sized bronze horses worth \$20,000. *Id.* The court further found that Mr. Cantu improperly transferred \$50,000 of what should have been estate assets to a close friend during the pendency of the case, that the Cantus suspiciously used estate cash throughout the bankruptcies, and that the Cantus were "uncooperative with the Court and the Trustee," often interfering with the sale of assets and filing frivolous lawsuits. *Id.*
8 *Id.* at 257.
9 *Id.* The bankruptcy court also entered an order authorizing the chapter 7 trustee to employ special counsel to investigate and pursue claims against and related to Stone, although the court did not rule on the question of ownership of those claims. *In re Cantu*, 2013 WL 2253201, at *1.

10 The district court denied the remand motion, and found that jurisdiction and removal of the suit was proper under 28 U.S.C. § 1334 because the claims against Stone arose prior to conversion to chapter 7 and were therefore included in the bankruptcy estate. *Cantu*, 784 F.3d at 256 n.4. In ruling on the remand motion, the district court applied the "middle-ground" or "pre-petition relationship" approach to determine whether the settlement proceeds belonged to the estate. *Id.* at 257. The bankruptcy court held that under both the test used by the district court or under the "accrual approach," the proceeds were estate property. Accordingly, to the extent that the Fifth Circuit Court of Appeals disagreed that the claims were property of the estate, the district court's jurisdictional ruling on the remand motion would also have had to have been reviewed on appeal. *Id.*

11 *Id.*
12 11 U.S.C. § 541(a)(1) (2014).
13 Section 1115(a)(1).
14 *Cantu*, 784 F.3d at 258.
15 129 F.3d 792, 795 (5th Cir. 1997).

continued on page 73

News at 11: In re Cantu: Timing Can Be Everything in Bankruptcy

from page 38

low the accrual approach, in finding this to be the appropriate standard.¹⁶ The accrual approach looks to when a debtor's cause of action is accrued under state law. Wrongful conduct alone will not suffice, and some form of legal injury must occur before causes of action are found to have accrued.¹⁷

There was some confusion in *Cantu* based on an earlier decision of the Fifth Circuit wherein the court applied the accrual approach to determine whether a legal malpractice claim was property of the estate.¹⁸ The *Wheeler* decision muddied the waters by also analyzing the issue under a different test: the "pre-petition relationship" test, in which "a claim arises at the time of the negligent conduct forming the basis for liability," even if no injury has yet occurred, so long as a pre-petition relationship existed between the claimant and debtor.¹⁹ Although this test was applied in *Wheeler* to determine whether a cause of action belonged to the debtor or the estate based on the timing of the claim, the test itself arose in the context of claims asserted against companies that had previously been in bankruptcy.²⁰ Thus, the Fifth Circuit made the following clarification:

the "pre-petition relationship" or "middle ground" test, which we first adopted in *Lemelle* to address whether a claim asserted against a restructured company had been discharged, does not apply to determining whether a claim that a debtor seeks to assert constitutes property of the estate.²¹

In *Cantu*, the parties agreed that Stone's wrongful conduct occurred pre-conversion. However, under applicable state law, "most causes of action do not accrue until the wrongful act caused an injury."²² Thus, the Cantus argued that the injury caused to them actually occurred post-conversion when they were denied their discharge and their assets were liquidated. The trustee acknowledged this, but countered that the estate was also injured by Stone's wrongdoings — injuries that occurred pre-conversion.²³

The Fifth Circuit focused its inquiry on whether Stone's misconduct, as alleged in the complaint, injured the estate "in a manner that would have enabled the trustee to file the lawsuit prior to conversion, ultimately concluding that Stone's misconduct indeed injured the estate in a number of ways that would have allowed the estate to pursue the claims prior to conversion."²⁴ The court specifically pointed to Stone's misconduct that led to the depletion of assets that would have otherwise gone to pay creditors, her failure to timely request the use of cash collateral and the diversion of assets by failing to schedule assets and by submitting an unconfirmable

plan, which the court found was "the culmination of Stone's misconduct."²⁵ The Cantus responded that any injuries to the estate that occurred pre-conversion due to pre-conversion misconduct were also injuries that were correctable prior to conversion. For example, the Cantus argued that even if the unconfirmable plan injured the estate, Stone could have amended that plan and submitted a new one to remedy the injurious deficiencies in the first plan.

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In rejecting this argument, the court explained that (1) the harm of the depleted assets and spent fees could not be undone and (2) "a claim accrues when an injury occurs; that injury need not be an irrevocable one."²⁶ Therefore, the possibility that Stone's subsequent conduct could have minimized harm to the estate did not undermine the court's conclusion that the estate had suffered sufficient pre-conversion injury to permit a lawsuit.²⁷

Conclusion

The Fifth Circuit ultimately concluded that the settlement proceeds from the malpractice claim against Stone and her firm were property of the estate, as they arose prior to the conversion of the Cantus case to chapter 7. The U.S. Supreme Court recently issued a decision relating to the interplay of conversion of a debtor's bankruptcy case and property of the estate — and the result was the opposite of that reached by the Fifth Circuit.

In *Harris v. Viegelahn*,²⁸ the Supreme Court recently held that post-petition wages held by the chapter 13 trustee prior to conversion from chapter 13 to chapter 7 belonged to the debtor and were not property of the bankruptcy estate upon conversion to chapter 7. *Harris*, however, is based on § 348(f) of the Bankruptcy Code, which states that post-petition, pre-conversion property of a chapter 13 debtor is not property of the chapter 7 estate upon conversion.

The result of the Fifth Circuit in *Cantu* was based on the interpretation of § 1115(a)(1), which provides that post-petition, pre-conversion property of the individual chapter 11 debtor is property of the estate upon conversion to chapter 7; there is no corresponding provision to § 1115(a)(1) in chapter 13. These cases should tell a cautionary tale to individual debtors and their counsel when considering chapter 11 or 13 — as it does matter where the debtor starts — and a subsequent conversion to chapter 7. **abi**

²⁵ *Id.*

²⁶ *Id.* at 263.

²⁷ *Id.*

²⁸ 135 S. Ct. 1829 (2015). For an analysis, see Katherine Rea and William A. McNeal, "Supreme Court Decides *Harris*: Conversion Conundrum Concluded," XXXIV *ABI Journal* 7, 36-37, 69, July 2015.

¹⁶ See, e.g., *In re O'Dowd*, 233 F.3d 197, 203 (3d Cir. 2000) (relying on New Jersey law to determine that "a legal-malpractice action accrues when an attorney's breach of professional duty proximately causes a plaintiff's damages"); *In re Alvarez*, 224 F.3d 1273, 1276-77 (11th Cir. 2000) (applying Florida law to determine that malpractice cause of action accrued against debtor's bankruptcy attorney who filed chapter 7 case instead of chapter 11 case the moment of the chapter 7 filing, and therefore belonged to bankruptcy estate).

¹⁷ *Cantu*, 784 F.3d at 258.

¹⁸ *Wheeler v. Magdovitz (In re Wheeler)*, 137 F.3d 299 (5th Cir. 1998) (*per curiam*).

¹⁹ *Id.* at 300-01.

²⁰ *Cantu*, 784 F.3d at 258 (citing *Lemelle v. Universal Mfg. Corp.*, 18 F.3d 1268 (5th Cir. 1994), and *In re Piper Aircraft Corp.*, 162 B.R. 619 (Bankr. S.D. Fla. 1994)).

²¹ *Id.* at 259.

²² *Id.* (citing *In re Swift*, 129 F.3d at 795 ("some form of legal injury must occur before these causes of action accrue.")).

²³ *Id.* at 260.

²⁴ *Id.* at 261.