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Secret Creditors

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Section 521(1) requires debtors to file a list of *all* creditors. If a debtor fails to comply with this mandate, costly amendments may be required, the case may have to be reopened years later, and in a worst-case scenario, the debtor could be denied a discharge of the claims held by creditors that are not scheduled. This article addresses an entire *category* of claims that often remain unlisted despite the directive in 11 U.S.C. § 521, because neither the debtor nor counsel are aware of their existence.

The existence of unknown claims is an ever-present problem in the bankruptcy world. To mitigate this threat, debtors are routinely advised to be as over-inclusive as possible when completing the list of creditors. This list will often include every employee who worked for the debtor. However, it will rarely include the names and addresses of every *employee of every vendor who had provided services to the debtor, the names and addresses of every service provider who worked on every property owned by the debtor, and the names and addresses of every customer who purchased products from the debtor*. The latter disclosures might seem over the top, if not within the realm of paranoid. But maybe they are not.

"Secret" claimholders within these constituencies can exist and can be substantial. These claims can include unknown workers' compensation and state labor code claims arising under particular statutes. These labor code sections allow, for example, the employees of a debtor's vendors to pursue the debtor for as long as a decade after a bankruptcy filing on a strict liability basis.

The Challenge of Preparing Accurate Schedules

In the best of circumstances, it is difficult for bankruptcy counsel to obtain accurate and complete information from a debtor, with supporting documents, prior to a chapter 7 filing. Debtors rarely understand the distinction between the term "creditor" (as in one who is owed money) and "claimholder" (a category that includes unliquidated, disputed and/or contingent liabilities), despite clear guidance from counsel. Statutes, such as those previously described, will only further exacerbate this burden.

Examples of Secret Creditors

Unknown Workers' Compensation Claims

One type of secret claim can arise from the workers' compensation system. These claims can expose a business owner to substantial liability and legal costs years after an accident occurs. For example, in California, workers' compensation claims are subject to a one-year statute of limitations from the date of *discovery* of a compensable disease.[1] This means that a former employee can bring a claim against a former employer/debtor for a work-related disease or injury long after a claims bar date, and long after a case has been closed. Florida and Texas appear to have similar *discovery* statutes of limitations.[2]

If the debtor had workers' compensation insurance, at least in California, the former employee would be compelled to pursue this omitted claim with the workers' compensation appeal board and with the debtor's insurer. This affords the debtor a measure of protection.[3] However, no protection is available if the workers' injuries are "discovered" and asserted after an asset case has closed, the claimholder did not receive timely notice of the bankruptcy and the employer cannot establish that insurance was in place.

Subcontractors and Contractors

In addition, if the debtor uses subcontractors, California Labor Code § 2750.5 makes the debtor liable as an "employer" for all a subcontractor's employees *if the subcontractor* fails to secure workers' compensation insurance.[4] This liability can also arise where a property owner/debtor has work performed at their residence by a worker who is not covered by workers' compensation insurance and a claim arises years later.[5] These workers' compensation statutes convert the employees of subcontractors, general contractors and all workers performing tasks on the debtor's property into potential claimholders — secret, unknown claimholders.

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1 Cal. Labor Code § 5405; *Arndt v. Workers' Comp. Appeals Bd.*, 56 Cal.App.3d 139, 144 (Cal. App. 1976) ("date of injury" means "the time when the accumulated effects culminate in a disability traceable to the latent disease as the primary cause, and by the exercise of reasonable care and diligence it is discoverable and apparent that a compensable injury was sustained in performance of the duties of the employment").

2 Fla. Stat. § 440.19 (petition must be "filed within [two] years after the date on which the employee knew or should have known that the injury or death arose out of work performed in the course and scope of employment"); Texas Labor § 409.003 ("An employee ... shall file with the division a claim for compensation for an injury not later than one year after the date on which: (1) the injury occurred; or (2) if the injury is an occupational disease, the employee knew or should have known that the disease was related to the employee's employment").

3 Cal. Labor Code § 3602.

4 *See Hernandez v. Chavez Roofing Inc.*, 235 Cal. App. 3d 1092, 1095 (Cal. App. 2 Dist. 1991) ("Section 2750.5 can create a dual-employment relationship whereby a worker may be an employee of both a general contractor and a subcontractor.... The price that must be paid by each employer for immunity from tort liability is the purchase of a worker's compensation policy.").

5 *Jones v. Sorenson*, 236 Cal. Rptr. 3d 271, 279, 25 Cal. App. 5th 933, 943 (Cal. App. 3 Dist. 2018) (homeowner is liable in torts for injuries to unlicensed contractor at his residence).

Statutory Rights to Sue: Garment Workers

Other labor-centric statutes can expand liability to third parties, creating a potential class of unknown claimholders for those third parties. One such example is found in California Labor Code § 2673.1, which is designed to protect Los Angeles garment workers, who have historically been paid less than minimum wage:

> (a) To ensure that employees are paid for all hours worked, a person engaged in garment manufacturing, as defined in Section 2671, who contracts with another person for the performance of garment manufacturing operations shall guarantee payment of the applicable minimum wage and overtime compensation, as required by law, that are due from that other person to its employees that perform those operations.[6]

For a manufacturer/debtor, California Labor Code § 2673.1 means that every employee of a subcontractor-manufacturer is a potential claimholder in the manufacturer/debtor's bankruptcy case. This body of potential claimholders could include hundreds or thousands of subcontractor employees who are unknown to the debtor/manufacturer, which creates a potentially massive hole in a debtor's bankruptcy notice.[7]

Strict Product Liability

If the debtor was involved in the retail sale of a product that is later determined to be defective, and a customer suffers an injury resulting from the use of the product, the customer has two years from the date the customer knew, or should have known, about the injury to assert a claim (not from the time the product was purchased).[8] In some instances, a product may not be deemed defective until years later or the customer could have paid for the product with cash, leaving no record. Accordingly, the debtor would have no ability to identify these customers and send them notice.

Secret Creditors in No-Asset Cases

In "no asset" cases, there is a level of protection from later collection attempts by omitted creditors,[9] as "the Bankruptcy Code discharges debts [that] are never listed on a schedule. If a creditor has knowledge of the debtor's bankruptcy case in time to file a proof of claim and to bring a § 523(2), (4) or (6) cause of action, the omission of the claim is not a bar to its discharge."[10] Thus, a discharge under 11 U.S.C. § 727 and the resulting permanent injunction under § 524 control in no-asset cases, even where creditors are omitted from a debtor's schedules. In *In re Nielsen*,[11] the Ninth Circuit held that any creditor's pre-petition claim omitted from the schedules of a no-asset chapter 7 case is discharged whether the creditor actually received notice or not.

In sum, case law supports the concept that where creditors are never required to file a proof of claim, the period within which a creditor must file a proof of claim never begins, and since it never begins, it never ends. Therefore, it is never too late to file a "timely" proof of claim, and the exception to discharge, set forth in 11 U.S.C. § 523(a)(3), does not apply, so unscheduled debts are discharged.

This discharge of unscheduled claims in a no-asset case still comes at the cost of either convincing the creditor that the discharge applies informally at the state court level,[12] or by reopening the bankruptcy case, scheduling and providing notice to the creditor. Reopening the bankruptcy case might come with increased risk of an adversary proceeding if the debtor has assets or resources after "recovering" from their prior discharge of debt.

Secret Creditors in an Asset Case

In an asset case, if a distribution has not yet been made, there is a window of opportunity to amend and send notice of an asset case to a previously unknown creditor even after the deadline to file a proof of claim has expired.[13] This line of cases holds that because 11 U.S.C. § 726(a)(2)(C) allows "claimants who did not receive notice of the bankruptcy case … to file a proof of claim [that] will be allowed as if the creditor had notice and had timely filed a proof of claim," § 523(a)(3)'s exception to discharge does not apply.

If a client does not identify and provide notice to a previously unknown claimant in time for the claimant to file a proof of claim and receive a distribution, the claim will be nondischargeable pursuant to § 523(a)(3). This circumstance becomes a real possibility when you consider the fact that it might not be possible for a client to obtain potential creditor contact information, *even if they know that particular potential creditor exists*.

Is There a Solution?

One possible solution to the secret claimant notice issue is to require all employees to direct their claims to the Department of Industrial Relations (DIR) (in California) or similar state agency. In California, the DIR oversees workers' compensation, health and safety, and other labor and employment issues. It provides the exclusive mechanism for workers' compensation claims as long as the employer had workers' compensation insurance. It provides a nonexclusive remedy for unpaid wages claims. Allowing debtors to give notice to the DIR of the bankruptcy and deeming such notice to be notice to all potential claimants is a possible solution.

If the debtor has workers' compensation insurance or homeowners' insurance (in the case of a homeowner who hires an unlicensed contractor who suffers injuries), any

6 Cal. Labor Code § 2673.1.

7 Likewise, a manufacturer/debtor might face liability for penalties when a subcontractor/manufacturer fails to register. Again, this is information that the manufacturer might not know they are able to schedule in a bankruptcy petition. *See* Cal. Labor Code § 2677 ("(a) Any person engaged in the business of garment manufacturing who contracts with any other person similarly engaged who has not registered with the commissioner or does not have a valid bond on file with the commissioner, as required by Section 2675, shall be deemed an employer, and shall be jointly liable with such other person for any violation of Section 2675 and the sections enumerated in that section.").

8 *Dominguez v. Hayward Indus. Inc.*, 201 So.3d 100, 101-02 (Fla. App. 3 Dist. 2015); Fla. Stats. §§ 95.11, 95.031; *Sevilla v. Stearns-Roger Inc.*, 101 Cal. App. 3d 608, 610-11 (Cal. App. 1980) ("[A]n injured employee's cause of action against the manufacturer of defective equipment runs from the date of injury, rather than the date the product was purchased.... Theoretically, manufacturers remain liable indefinitely for injuries proximately caused by their defective products."); *Texas Civ. Prac. & Rem.* § 16.012 (15 years).

9 *In re Beezley*, 994 F.2d 1433, 1436 (9th Cir. 1993).

10 *In re Peacock*, 139 B.R. 421, 424 (Bankr. E.D. Mich. 1992); *see also id.*; § 523(a)(3); *In re Soult*, 894 F.2d 815, 817 (6th Cir. 1990) (noting that omission must not be willful).

11 383 F.3d 922 (9th Cir. 2004).

12 "State and federal courts have concurrent jurisdiction over actions brought under § 523(a)(3), which allows debtors to extend the coverage of the discharge order to creditors who were not listed but who had actual notice of the bankruptcy proceedings." *In re McGhan*, 288 F.3d 1172, 1181 (9th Cir. 2002).

13 *In re Horlacher*, 2009 WL 903620, at *4 (N.D. Fla. 2009) ("Thus, § 523(a)(3)(A) is 'inapplicable to the situation where the creditor receives notice of the bankruptcy case too late to allow the filing of a claim by the bar date, but in time to allow the creditor to file a proof of claim prior to distribution.'"); *In re Ricks*, 253 B.R. 734, 744 (Bankr. M.D. La. 2000); *In re Snyder*, 544 B.R. 905, 909 (Bankr. M.D. Fla. 2016).

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unknown workers' compensation claims that the debtor learns of can be satisfied through insurance. However, this assumes that the debtor maintains records of insurance policies indefinitely and that coverage is not subject to a "claims made" deadline.

Notice by Publication

Another solution for debtors who suspect they might have secret but unknown creditors is to obtain court approval for notice by publication. Due process is satisfied if unknown claimholders who hold potential or speculative claims receive notice by publication.[14] A bankruptcy court explained in *In re Energy Future Holdings Corp*.[15] the level of notice required to unknown creditors:

> A debtor must provide actual notice to all "known creditors" in order to discharge their claims. Known creditors include both claimants actually known to the debtor and those whose identities are "reasonably ascertainable." "A creditor's identity is reasonably ascertainable if that creditor can be identified through reasonably diligent efforts. Reasonable diligence does not require impracticable and extended searches. The requisite search for a known creditor, instead, usually requires only a careful examination of a debtor's books and records." By contrast, the debtor need only provide "unknown creditors" with constructive notice by publication. Constructive notice must be "reasonably calculated, under the circumstances, to apprise interested parties of the pendency of the action and afford them an opportunity to present their objections." "Publication in national newspapers is regularly deemed sufficient notice to unknown creditors, especially where supplemented ... with notice in papers of general circulation in locations where the debtor is conducting business."

A diligent bankruptcy attorney must confer with a debtor to determine the probability of unknown claimholders and the amount of their potential debt to advise the debtor as to whether the cost of a motion to the court to allow notice by publication is in the debtor's best interest.

A Court-Adopted Form Motion for Notice

A better solution would be a court-adopted form motion that asks debtors to identify past financial circumstances, indicate due-diligence efforts to identify potential creditors and request case-specific orders for how to give notice by publication in cost-sensitive ways. Notice by publication is commonly allowed in, for example, asbestos cases, where there is a large body of potential unknown claimholders. Such a mechanism would protect the right of the honest, unfortunate and diligent debtor to receive the benefit of a full discharge of pre-petition-based claims in asset cases.

Conclusion

Given the foregoing risks, counsel should make an effort to ascertain whether "secret" claims of the kind addressed in this article may exist. If they do, notice by publication might be the only practical option. To limit the burdens on the courts and the bar, each jurisdiction should adopt a form motion and order providing this relief. abi

14 *In re Gencor Indus. Inc.*, 298 B.R. 902, 916-17 (Bankr. M.D. Fla. 2003) ("[C]reditors holding 'merely conceivable, conjectural, or speculative claims' are not entitled to receive actual notice in a bankruptcy case."); *In re Placid Oil Co.*, 463 B.R. 803, 817 (Bankr. N.D. Tex. 2012).

15 522 B.R. 520, 529 (Bankr. D. Del. 2015).