The Importance Of Being Earnest About Bankruptcy

Law360, New York (November 08, 2011, 11:55 AM ET) -- A defense attorney who reached what she believed was an especially favorable settlement with an employment discrimination plaintiff may have paid out a "gift" to an individual who had no standing to litigate the suit from the outset, and no authority to enter into a settlement agreement. She learned this upon receiving a call from the trustee responsible for administering a Chapter 7 bankruptcy petition filed by the plaintiff, an action of which she was completely unaware.

She also learned from the trustee that the employment lawsuit recently came to his attention, and that the plaintiff should have disclosed it in his bankruptcy filing, but did not. This deprived his creditors of the "asset" represented by those claims, and deprived the trustee of the ability to consider the value of the lawsuit in distributing the estate to the creditors. Now, after having forwarded settlement checks to the plaintiff's counsel, received a fully executed release, and filed a dismissal with prejudice, defense counsel is advised by the trustee that he had been the real party in interest all along, and that he would be filing a motion to vacate the dismissal and reinstitute the lawsuit in his role as trustee.[1]

Chapter 7 bankruptcy petitions have increased significantly in recent years. Nonbusiness bankruptcies increased to 1,536,799 in 2010, a 9 percent increase from 2009, and in October 2011 such filings increased by 19.6 percent over October 2010. The need to seek bankruptcy protection can be related to the loss of employment, and discharge from employment is a common predicate in employment litigation. Any claim that seeks monetary damages, employment-based or otherwise, can be substituted in this analysis, however, and employment lawsuits are used here for illustrative purposes only.

In those cases in which a plaintiff in an employment suit has properly disclosed his claim in bankruptcy proceedings, the trustee may "abandon" the suit as insufficiently valuable for distribution to the creditors, leaving the litigation to proceed as it otherwise would. The trustee "owns" the claims, however, and may decide to substitute for the plaintiff as the real party in interest, and take over the litigation, including perhaps hiring substitute counsel.[2]

In those cases in which a plaintiff has not disclosed his claims in the bankruptcy petition, and defense counsel discovers this, a defendant can move to dismiss the plaintiff's action under Federal Rule of Civil Procedure 12(h), or similar state court rule, depending upon the venue. Under the doctrine of judicial estoppel, a court can dismiss a plaintiff's action in its entirety as a result of the failure to disclose claims in a bankruptcy petition.[3]

The common law doctrine of judicial estoppel is used to prevent a party from asserting inconsistent positions in separate cases, thus gaining an unfair advantage, and causing potential damage to the integrity of the judicial process. In such cases, courts will consider whether the failure to disclose the lawsuit in bankruptcy court was a deliberate or intentional manipulation, or simply "inadvertent."

In cases of inadvertence, plaintiffs have been allowed to amend their bankruptcy petitions to include their lawsuits, thus leaving the trustees to determine what course to take. Where not inadvertent, however, the application of judicial estoppel to dismiss a plaintiff's lawsuit entirely should not be considered a certainty. Complete dismissals of lawsuits are recognized as having the unintended effect of depriving the trustee, and more importantly the creditors, who are otherwise "innocent" parties, of an asset belonging to the bankruptcy estate.

A lawsuit alleging violation of the Family and Medical Leave Act against the City of Arlington, Texas, illustrates the competing interests in such a case and the complications that can arise.[4] There, the plaintiff won a judgment in excess of a million dollars against the city. During the course of an appeal by the city to the Fifth Circuit Court of Appeals, the plaintiff and his wife filed a Chapter 7 bankruptcy petition, and failed to disclose the judgment received in the FMLA claim. The bankruptcy case was closed without knowledge by the trustee of this significant judgment, or of the city's appeal.

Upon remand to the district court to recalculate the damage award, plaintiff's attorney learned of the bankruptcy, and notified the trustee of the judgment. The trustee then reopened the bankruptcy, substituted into the FMLA litigation as the real party in interest, and accepted an offer of judgment that the city had made to plaintiff, now for distribution to the creditors. The city then sought to have the judgment extinguished based on judicial estoppel for plaintiff's failure to disclose the lawsuit to the trustee.

Ultimately, the Fifth Circuit affirmed a judgment of the district court that the plaintiff was estopped from receiving any money from the judgment against the city, but that the trustee could collect the judgment on behalf of the creditors, with the remainder, if any, being returned to the city and not to the plaintiff.

In a similar case, the Fifth Circuit also rejected the complete dismissal of a lawsuit for failure of the plaintiff to disclose his suit in bankruptcy court, noting the potential adverse impact on innocent creditors. The court held that using equitable estoppel in a way that deprived creditors of a judgment would be using the doctrine to "land another blow on the victims of bankruptcy fraud," not, according to the court, an equitable result.[5]

It is clear from the case law that a variety of adverse consequences can result from the failure of a plaintiff to disclose a concurrent or potential lawsuit in a bankruptcy petition, for example: (1) a plaintiff can face dismissal of potentially valuable claims through the doctrine of judicial estoppel; (2) a plaintiff's lawyer can find that her client is not the real party in interest, and that neither she nor the client can benefit from an otherwise successful litigation; and (3) a defendant can pay a settlement or judgment to a person with no standing in the litigation, and face the potential for a "second litigation" with a trustee, the real party in interest.

Understanding these issues is a start to avoiding their pitfalls. Plaintiff's attorneys can make questions regarding bankruptcy part of their intake interviews, and defense attorneys can make such questions part of their discovery requests. Both can easily check the dockets of local bankruptcy courts. However it is accomplished, attorneys on both sides should make efforts to insure that a flawed bankruptcy petition is not lurking in the background of their litigation, capable of unforeseen complications and adverse consequences.

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[1] 11 U.S.C. § 323 (2010).

[2] Barger v. Cartersville, 348 F.3d 1289, 1292 (11th Cir. 2003).

[3] Hamilton v. State Farm Fire & Cas. Co., 270 F.3d 778, 785 (9th Cir. 2001).

[4] Reed v. City of Arlington, No. 08-11098, 2011 WL 3506100 (5th Cir. Aug. 11, 2011).

[5] Kane v. Nat'l Union Fire Ins. Co., 535 F.3d 380, 388 (5th Cir. 2008).