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Identifying Defenses Arising From A Plaintiff's Bankruptcy

Law360, New York (August 02, 2012, 1:43 PM ET) -- High levels of unemployment and a slow economic recovery have led to a steady increase in nonbusiness bankruptcy filings over the past several years. In fact, over 1.43 million nonbusiness bankruptcies were commenced in 2011.[1]

With such high levels of bankruptcy filings, the chances are good that you are, or will be, defending against a nonbankruptcy action initiated by a person who is in bankruptcy or has recently emerged from bankruptcy. With a little research, an attorney defending against such an action may be able to identify additional defenses based on positions taken by a debtor in his or her bankruptcy proceeding to use in a subsequent action (the action) commenced by the debtor.

This article summarizes three defenses — lack of standing, judicial estoppel and res judicata — that all arise from the disclosures or nondisclosures by a debtor in his or her bankruptcy proceeding. Each of these defenses could be incorporated into a motion to dismiss or motion for summary judgment in the action, and, if adopted by the court, may preclude the debtor from continuing with the action.

Lack of Standing

As most attorneys learn in their constitutional law class, standing is a threshold issue of any federal or state action.[2] What usually is not addressed, however, is that a debtor may be divested of standing to assert claims as a result of filing for bankruptcy protection.

When a debtor files a voluntary petition for bankruptcy protection, a bankruptcy estate is created consisting of certain property owned by the debtor before he or she filed for bankruptcy.[3] Property of the bankruptcy estate is broadly defined and encompasses all legal and equitable interests of the debtor in property as of the commencement of the case.[4]

This broad definition includes potential causes of action of the debtor arising from prepetition events. Failure of a debtor to properly identify and treat prepetition causes of action in a proceeding under Chapter 7 of the Bankruptcy Code and Chapter 11 of the Bankruptcy Code may divest that debtor of standing to later asserting those claims.[5]

In a proceeding under Chapter 7, a trustee is appointed to be the representative of the estate.[6] As the representative of the estate, the Chapter 7 trustee is vested with the property of the estate, including prepetition causes of action, to liquidate that property for the benefit of the creditors. As a result, courts generally recognize that the Chapter 7 trustee alone is vested with the exclusive power to assert legal claims on behalf of the estate, including debtor's prepetition causes of action.[7]

Therefore, a debtor that filed for bankruptcy protection under Chapter 7 likely would lack standing to bring causes of action based on prepetition events after he or she has commenced a bankruptcy proceeding, because the cause of action is property of the bankruptcy estate and vested in the Chapter 7 trustee.

Exceptions to this general rule do exist. Of note, a Chapter 7 trustee can abandon causes of action back to a debtor if the Chapter 7 trustee believes a cause of action is of inconsequential value to the estate.[8]

However, to abandon a cause of action, a Chapter 7 trustee must be aware of it. Chapter 7 trustees generally become aware of prepetition causes of actions only after a debtor properly identifies these actions in the debtor's schedules of assets and liabilities.[9]

In practice, unsophisticated debtors rarely properly identify potential causes of action in their schedules. As a result, a Chapter 7 trustee may never become aware of the cause of action and, in turn, will never have sufficient knowledge to abandon the prepetition causes of action. In such instances, prepetition causes of actions potentially could remain property of the bankruptcy estate even after debtor receives a discharge and the case is closed.[10]

Additionally, even if a prepetition cause of action is properly identified, a Chapter 7 trustee is required to provide notice of abandonment to all creditors prior to any abandonment.[11] Therefore, attorneys should review the debtor's schedules and the bankruptcy docket to determine whether the cause of action being asserted in the action was properly identified by the debtor and abandoned by the Chapter 7 trustee.

If neither has occurred, the debtor may lack standing to bring the action while the bankruptcy case is pending. However, once the bankruptcy case is closed, the cause of action would be abandoned back to the debtor.[12]

Although fairly unusual[13], the court also may appoint a trustee in a proceeding under Chapter 11. Like a Chapter 7 trustee, a trustee appointed in a Chapter 11 case is the representative of the estate and vested with the exclusive power to assert legal claims on behalf of the estate.[14]

What is more common in Chapter 11 cases is for a plan of reorganization to assign debtor's prepetition causes of action to a third party. For example, prepetition claims may be assigned through the plan to a liquidating agent or litigation agent who has the sole ability to initiate causes of action on behalf of the estate. A review of debtor's plan of reorganization therefore may reveal that debtor's causes of action have been assigned to a third party, thereby divesting debtor of standing to bring the action.

Judicial Estoppel

Judicial estoppel also may also provide an additional defense against claims asserted by a debtor. Unlike standing, judicial estoppel is an equitable doctrine that precludes a party from gaining an unfair advantage by taking an incompatible position.[15]

The purpose behind judicial estoppel is to protect the integrity of the judicial process, and it is typically invoked when a litigant tries to "play fast and loose with the courts."[16]

The generally accepted elements of judicial estoppel are:

1. A party's earlier and later positions must be clearly inconsistent;
2. The party must have succeeded in persuading a court to accept the earlier position; and
3. The party seeking to assert inconsistent positions must stand to derive an unfair advantage if the court adopts the new position.[17]

In the context of a bankruptcy proceeding, judicially estoppel can appear where a debtor fails to make adequate disclosures in Chapter 7, Chapter 11 or Chapter 13 cases.

For example, a debtor in a Chapter 7 case that fails to identify any prepetition claims in his or her schedules may be judicial estoppel from asserting those claims after receiving a discharge.[18] Courts reason that, by not disclosing any potential causes of action, the debtor is taking the position that he or she does not have any causes of action based on prepetition events.[19]

This position is then "accepted" by the court when it entered the order granting debtor a discharge. By later initiating a lawsuit based on prepetition events, the debtor is taking an inconsistent position after benefiting from the automatic stay and obtaining a discharge order. Judicial estoppel can act to bar the debtor from gaining an unfair advantage through such incompatible position.

Judicial estoppel may arise from debtor's Chapter 11 cases where he or she does not disclose potential causes of actions in his or her disclosure statement. A disclosure statement is required in every Chapter 11 case to support the debtor's plan of reorganization. The disclosure statement is intended to provide parties-in-interest with "adequate information" to make an informed decision about whether to vote in favor of or against the plan.[20]

A debtor in a Chapter 11 case that does not disclose potential causes of actions in his or her disclosure statement or preserve those causes of action in its plan of reorganization is taking the position that he or she does not have any prepetition causes of action.[21] This position is accepted when the court enters an order confirming the plan. Accordingly, the debtor likely would be estopped from asserting an undisclosed prepetition claim after the plan confirmation.

Though a debtor in a Chapter 13 case is not required to file a disclosure statement in support of its plan, judicial estoppel may still apply in these cases as a debtor in a Chapter 13 case still has the obligation to identify potential cause of action in his or her schedules.[22]

Further, a debtor in a Chapter 13 case may acknowledge in the schedules a debt owed to the defendants in the action or fail to object timely to a claim filed by the defendants in the Chapter 13 case. If the debtor's plan then provides for payments to the defendant based on the debt set forth in debtor's schedules or the proof of claim without identifying or preserving any setoffs or counterclaims, the debtor arguably is taking the position that it owes the defendant the full amount of the debt.[23] As such, the debtor may be estopped for asserting a later undisclosed cause of action following confirmation of the Chapter 13 plan.

Res Judicata

Finally, if the defendants in the action were a party to the debtor's prior bankruptcy proceeding, or is in privity with a party to the debtor's prior bankruptcy proceeding, res judiciata may act to bar the action. Res judicata precludes a party from asserting claims that could or should have been raised during the pendency of a prior case when there is:

1. An identity of claims;
2. A final judgment on the merits; and
3. Privity between parties.[24]

In the context of Chapter 11 and Chapter 13 cases[25], orders confirming plans of reorganization are binding, final orders and are accorded full res judicata effect.[26]

As with judicial estoppel, a debtor in a Chapter 11 case that fails to identify prepetition causes of action in the debtor's disclosure statement or preserve the right to litigate claims in the debtor's plan of reorganization may be precluded from litigating those prepetition claims postconfirmation.[27]

Courts have even held that blanket reservations that purportedly reserve all causes of action to be insufficient to prevent the application of res judicata to a specific action.[28]

Courts similarly have applied res judicata to bar a debtor in Chapter 13 cases from asserting postconfirmation action against creditors. However, res judicata is more likely to apply in a Chapter 13 case where the debtor failed to identify any potential claims against a creditor his or her schedules or object to that creditors' proof of claim.[29]

Accordingly, where an order confirming a plan has been entered in either a Chapter 11 or Chapter 13 case, attorneys should pay close attention to whether res judicata may apply to bar debtor's action.

Conclusion

As the number of bankruptcy proceedings increase, the probability also increases that you will encounter a plaintiff that is, or recently was, a debtor in a bankruptcy proceeding. A review of the debtor's bankruptcy disclosures, especially the schedules, disclosure statement and plan of reorganization, may give rise to additional defenses to help defend an action asserted after the commencement of the bankruptcy proceeding.

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[1] U.S. Courts, U.S. Bankruptcy Courts – Business and Nonbusiness Cases Commenced, by Chapter of the Bankruptcy Code, During the 12-Month Period Ending December 31, 2011, www.uscourts.gov/Statistics/BankruptcyStatistics.aspx (last visited July 18, 2012) [hereinafter Business and Nonbusiness Cases for 2012].

[2] Local Nos. 175 & 505 Pension Trust v. Anchor Cap., 498 F.3d 920, 923 (9th Cir. 2007) (quoting Lujan v. Defenders of Wildlife, 504 U.S. 555, 561 (1992)).

[3] The time period before filing a voluntary petition for bankruptcy protection is referred to in this Article as "prepetition," and the time period after filing a voluntary petition is referred to as "postpetition."

[4] 11 U.S.C. § 541(a)(1).

[5] The lack of standing argument usually does not apply where Debtor filed a proceeding under Chapter 13. In Chapter 13, the Debtor remains in possession of all property of the estate preconfirmation. 11 U.S.C. § 1306(b). And, unless otherwise provided for in the plan, property of the estate vests in the Debtor postconfirmation. 11 U.S.C. § 1327(b).

[6] 11 U.S.C. §§ 323(a), 704.

[7] 11 U.S.C. §§ 323(b), 704; Estate of Thelma v. Spirtos, 443 F.3d 1172, 1176 (9th Cir. 2006); Moneymaker v. CoBen, 31 F.3d 1147, 1451 n.2 (9th Cir. 1994); Parker v. Wendy's Int'l, Inc., 365 F.3d 1268, 1272 (11th Cir. 2004).

[8] 11 U.S.C. § 554(a).

[9] Item 21 of Official Form 6B (12/07) asks debtors to identify "[o]ther contingent and unliquidatd claims of every nature, including tax refunds, counterclaims of the debtor, and rights to setoff claim."

[10] If an asset is not properly identified in the schedules of assets and liabilities, it cannot be abandoned by the chapter 7 trustee and may remain property of the estate even after the Debtor is discharged and the bankruptcy proceeding is closed. Cundiff v. Cundiff (In re Cundiff), 227 B.R. 476, 479 (B.A.P. 6th Cir. 1998); Pace v. Battley (In re Pace), 146 B.R. 562, 564 (B.A.P. 9th Cir. 1992).

[11] Fed. R. Bankr. P. 6007(a)-(b).

[12] 11 U.S.C. § 554(c); see In re Reed, 940 F.2d 1317, 1321 (9th Cir. 1991) ("Although filing [by the trustee of] a 'No Asset' report may exhibit the requisite intent to abandon an asset, that report in and of itself cannot result in abandonment unless the court closes the case.").

[13] In 2011, nonbusiness Chapter 11 filings totaled 1,757 in comparison to 958,634 Chapter 7 cases and 404,454 Chapter 13 cases. See Business and Nonbusiness Cases for 2012, supra note 1. Additionally, the appointment of a trustee in a nonbusiness bankruptcy proceeding is only done after a finding of cause, such as fraud, dishonesty, or incompetence. 11 U.S.C. § 1104(a)(1).

[14] 11 U.S.C. §§ 323, 1106(a)(1).

[15] Whaley v. Belleque, 520 F.3d 997, 1002 (9th Cir. 2008).

[16] New Hampshire v. Maine, 532 U.S. 742, 749-50 (2001); Hamilton v. State Farm Fire & Cas. Co., 270 F.3d 778, 782 (9th Cir. 2001).

[17] Maine, 532 U.S. at 750-51; Hamilton, 270 F.3d at 782-83.

[18] Hamilton, 270 F.3d at 783; Hay v. First Interstate Bank of Kalispell, N.A., 978 F.2d 555, 557 (9th Cir. 1992).

[19] Hamilton, 270 F.3d at 784 ("[A] debtor who failed to disclose a pending claims as an asset in a bankruptcy proceeding where debts were permanently discharged was estopped from pursuing such claim in a subsequent proceeding." (citing Hay, 978 F.2d at 557)).

[20] 11 U.S.C. § 1125(a)(1).

[21] Hamilton, 270 F.3d at 784; Hay, 978 F.2d at 557; Oneida Motor Freight, Inc. v. United Jersey Bank, 848 F.2d 414, 416 (3d Cir. 1988); Payless Wholesale Distribs., Inc. v. Alberto Culver, Inc., 989 F.2d 570, 571 (1st Cir. 1993).

[22] Because a chapter 13 bankruptcy estate includes property acquired by a debtor after the filing of the petition but before the case is closed, the debtor may be judicially estopped from asserting claims arising postpetition that debtor never disclosed in a supplemental or amended schedule of assets and liabilities. See, e.g. In re Kemp, Case No. 03-52422, 2011 Bankr. LEXIS 3197, at *9-11 (W.D. La. Aug. 19, 2011) ("[T]he weight of authority imposes a continuing obligation on Chapter 13 debtors to disclose post-petition causes of action, and a debtor's failure to disclose such causes of action may result in application of judicial estoppel.").

[23] In re Abraham, Case No. 10-05354, 2010 Bankr. LEXIS 4872, at *8-9 (Bankr. D.S.C. Sept. 20, 2010); In re Munoz, Case No. 09-10731, 2011 Bankr. LEXIS 2410, at *2-3 (Bankr. S.D. Tex. June 21, 2011); DeLeon v. Comcar Industries, Inc., 321 F.3d 1289 (11th Cir. 2003).

[24] Tahoe-Sierra Pres. Council, Inc. v. Tahoe Reg'l Planning Agency, 322 F.3d 1064, 1077 (9th Cir. 2003)

[25] The application of res judicata discussed in this Article is based upon the order confirming a plan under Chapter 11 or Chapter 13. Because plan confirmation is not part of a Chapter 7 case, Chapter 7 is not addressed in this section.

[26] 11 U.S.C. §§ 1141(a), 1347(a); Heritage Hotel Ltd. P'Ship I v. Valley Bank of Nevada, 160 B.R. 374, 377 (9th Cir. B.A.P. 1993), aff'd, 59 F.3d 175 (9th Cir. 1995); In re Duke, 153 B.R. 913 (Bankr. N.D. Ala. 1993); In re Evans, 30 B.R. 530 (9th Cir. BAP 1983).

[27] Kelley v. S. Bay Bank (In re Kelley), 199 B.R. 698, 703-04 (9th Cir. B.A.P. 1996); see also Mickey's Enters., Inc. v. Saturday Sales, Inc., 165 B.R. 188 (Bankr. W.D. Tex. 1994); Celli v. First Nat'l Bank of N. New York, 460 F.3d 289, 292-93 (2d Cir. 2006).

[28] In re Kelley, 199 B.R. at 704 (internal citations omitted); see also D & K Prop. Crystal Lake v. Mut. Life Ins., 112 F.3d 257, 259 (7th Cir. 1997); Browning v. Levy, 283 F.3d 761 (6th Cir. 2002).

[29] In Clark, 172 B.R. 701, 703-04 (Bankr. S.D. Ga. 1994); In re Marlow, 216 B.R. 975, 980-81 (Bankr. N.D. Ala. 1998); In re Breauxsaus, 304 B.R. 273, 275-76 (Bankr. N.D. Ms. 2003).