

Bankruptcy: Behold or Beware?

By: *Betty Ruth Fox*¹

“Have you ever filed for bankruptcy?” may be the single most important question a lawyer asks a client. Nondisclosure of claims in bankruptcy which are later pursued by the debtor are often successfully defended based solely on judicial estoppel as demonstrated by Reed v. City of Arlington, 620 F.3d 477 (5th Cir. 2010).² Therein, the Fifth Circuit held that judicial estoppel not only barred the debtor, but also the bankruptcy trustee, from collecting a \$1,000,000 judgment the debtor failed to disclose in the bankruptcy schedules he filed after he obtained the judgment. The result: the otherwise liable City paid nothing, the trustee and the creditors received nothing, and the damaged debtor received nothing *except a revocation of his discharge*.

This article will first provide a brief review of bankruptcy basics followed by an in depth discussion of judicial estoppel and Reed v. City of Arlington. It continues with issues raised by judicial estoppel and concludes with practice tips from various perspectives. Note that the Mississippi Supreme Court recently refused to apply judicial estoppel to bar recovery of a debtor on a claim even though the debtor was involved in an active chapter 13 bankruptcy proceeding and failed to list the claim on her schedules. See Copiah County v. Oliver, No. 2009-IA-00809 (Miss. Sept. 30, 2010). Oliver is distinguishable based on the fact that the debtor’s claim arose after the date she filed for bankruptcy and after the date of confirmation of her chapter 13 plan. The court noted that had Ms. Oliver’s “cause of action arisen prior to her bankruptcy’s commencement, she certainly would have been obligated to disclose it for inclusion in the estate.” Oliver, slip op. at 9. The Court discussed at length the unsettled nature of the law with respect to whether a claim which accrues post confirmation in a chapter 13 bankruptcy is property of the estate that requires disclosure in the bankruptcy schedules. Id. at 11-12. The holding in Oliver is consistent with the cases and analysis presented in this article since the discussion in this article focuses on nondisclosure of claims that arose before the bankruptcy filing. A discussion of bankruptcy basics follows.

I. Bankruptcy Basics

The filing of a petition creates an estate in bankruptcy which consists of all property owned by the debtor, or any interest of the debtor in any property, as of the date the petition is filed.³ Estate property includes all legal or equitable interests of the debtor in property, including causes of action, claims (including contingent and/or unliquidated claims) and judgments.⁴ Property of the bankruptcy estate remains property of the estate until it is either administered or abandoned under the terms of the Bankruptcy Code.⁵ The trustee is the representative of the estate and has the capacity to sue and be sued.⁶

The initial filing of a bankruptcy petition results in the imposition of the automatic stay. Specifically, 11 U.S.C. §362 of the Bankruptcy Code provides that the filing of a bankruptcy petition operates as a stay of the continuation of an action against the debtor, any act to obtain property of the bankruptcy estate, or any act to create, perfect or enforce any lien against property of the debtor.⁷ This stay is applicable to all entities, and it is extremely important that care be taken to not take any action in violation of the automatic stay. 11 U.S.C. §362(k)(1) provides that: “[e]xcept as provided in paragraph (2), an individual injured by any willful violation of a stay provided by this section shall recover actual damages, including costs and attorneys’ fees, and, in appropriate circumstances, may recover punitive damages.”

A party violates the automatic stay if it takes action with respect to estate property without obtaining an appropriate order from the bankruptcy court, regardless of whether the party has actual knowledge of the bankruptcy or not. Liability is strict.

II. Judicial Estoppel

Despite the threat of violating the automatic stay and the potential penalties, some debtors pursue claims not disclosed during their bankruptcy. In many cases, judicial estoppel has been successfully used to preclude recovery on undisclosed claims.

Judicial estoppel protects the integrity of court proceedings by preventing a party from asserting a claim in a legal proceeding that is inconsistent with a claim taken by that party in a previous proceeding. New Hampshire v. Maine, 532 U.S. 742, 749 (2001).

The requirements for judicial estoppel are: (1) inconsistent positions, (2) the court’s acceptance of inconsistent positions, and (3) absence of inadvertence. Superior Crewboats, Inc. v. Primary P&I Underwriters (In re Superior Crewboats, Inc.), 374 F.3d 330, 335 (5th Cir. 2004). Judicial estoppel is applied in the context of a bankruptcy in cases in which debtors fail to disclose claims in their bankruptcy proceeding and then later pursue the claims without disclosure to the bankruptcy trustee. “In considering judicial estoppel for bankruptcy cases, the debtor’s failure to satisfy its statutory disclosure duty is “inadvertent” only

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when, in general, the debtor either lacks knowledge of the undisclosed claims or has no motive for their concealment.” Browning Manufacturing v. Mims (In re: Coastal Plains, Inc.), 179 F. 3d 197, 210 (5th Cir. 1999)

As mentioned above, in Reed v. City of Arlington, the Fifth Circuit held that both the debtor and the trustee were judicially estopped from collecting a \$1 million-plus judgment obtained by the debtor against the City of Arlington. 620 F.3d at 483. In Reed, Kim Lubke obtained a \$1 million-plus verdict against the City of Arlington, Texas, pursuant to the Family Medical Leave Act (FLMA) on May 13, 2004, from which the City appealed. Id. at 479. During the pendency of the appeal, on June 10, 2005, Lubke and his wife filed a chapter 7 bankruptcy petition but did not include the pending \$1 million judgment in the bankruptcy filings and sworn statements. Id. The Lubke’s chapter 7 case was listed as a “no asset [case]” and the debtors received a discharge of \$300,000 in debt. Id. Thereafter, on July 31, 2006, the City offered Lubke a Rule 68 judgment for \$580,000. Id. at 480. When Lubke’s attorney, Hurlbut, called him to discuss the offer, Lubke apparently advised Hurlbut about his prior bankruptcy filing for the first time. Id. On August 3, 2006, Hurlbut informed the Chapter 7 trustee appointed in the Lubkes’ case of Lubke’s judgment against the City. Id. On August 7, the Trustee and Lubke agreed to seek reopening of the Chapter 7 case, which was reopened on August 10. Id. The Trustee attempted to accept the City’s Rule 68 offer and filed a motion to substitute herself for Lubke in district court. Id. Thereafter, the City filed a supplement to its petition for rehearing seeking a take-nothing judgment against Lubke, arguing that he should be judicially estopped from collecting due to his failure to schedule the judgment in the bankruptcy case. On December 5, 2006, the bankruptcy court revoked Lubke’s discharge. Id. On December 19, 2006, the Fifth Circuit denied the City’s petition for rehearing but remanded the case to the district court to recalculate damages and to rule initially on the city’s judicial estoppel claim. Id. The district court ratified its substitution of the Trustee for the Debtor, reduced the damages per the Fifth Circuit’s instructions and awarded additional attorney’s fees, and also ordered a novel judicial estoppel remedy in which it ordered the City to pay the entire judgment to the Trustee but ordered that any remaining funds be returned to the City. Id.

On appeal, the Fifth Circuit concluded that both the Debtor and the Trustee were judicially estopped from recovering any amount from the City. The Court noted that even though the trustee had not taken an inconsistent position herself, she succeeded to the Debtor’s claim with all its attributes. Id. at 482. The Court also noted that only about one-sixth of the original creditors timely refiled when the case was reopened as an “asset” case after discovery of the \$1 million dollar judgment, hence, the majority of the creditor body would not recover any monies even if the Court did not apply judicial estoppel against the Trustee. Id. at 482-483. The Court concluded that “[n]ot to uphold judicial estoppel in this instance would send debtors the message that they ‘should consider disclosing personal assets only if [they are] caught concealing them.’” Id. at 483 (quoting In re Superior Crewboats, 374 F.3d at 336 [quoting Burnes v. Pemco Aeroplex, Inc., 291 F. 3d 1282, 1288 (11th Cir. 2002)]).

In rendering its decision in Reed, the Court struggled to distinguish a recent decision in which it reached a different result. In Kane v. National Union Fire Insurance Co., 535 F.3d 380 (5th Cir. 2008), the Fifth Circuit refused to apply judicial estoppel to bar recovery on a claim the debtors failed to disclose during their bankruptcy. Id. at 383. The debtors had appealed the district court’s grant of summary judgment in favor of the defendants on grounds of judicial estoppel and the trustee appealed the district court’s dismissal as moot of his motion to be substituted as the real party in interest. Id. The Court reversed and remanded stating that “the only way the [debtors’] creditors would be harmed is if judicial estoppel were applied to bar the Trustee from pursuing the claim against Defendants on behalf of the estate. In this case, equity favors the Trustee.” Id. at 387.

III. General Practice Tips

Bankruptcy trustees are required to question debtors regarding the completeness and accuracy of their schedules and statements, including any claims debtors may have. The most effective question of which I am aware is: “[D]o you think you have any reason to sue anybody for anything?” This question is appropriate to be asked by a bankruptcy trustee, a creditor or any party attending the meeting of creditors, and debtors must be reminded that any claim must be disclosed, regardless of whether the debtor thinks it has value or is worthless.

Attorneys for debtors should remind their clients regarding the potential penalties for failure to disclose property in bankruptcy, including revocation of discharge and/or referral to the United States Attorney for criminal prosecution for bankruptcy fraud.

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Attorneys must be diligent in checking for bankruptcy filings of clients and all other parties involved. Clients should be asked about bankruptcy and Public Access to Court Electronic Records (PACER) should be checked for each party. Client questionnaires and PACER printouts should be retained in an attorney's file to document that a bankruptcy inquiry was made. An attorney cannot represent a party in bankruptcy without bankruptcy court approval. Failure to obtain bankruptcy court approval is a violation of the automatic stay for which a person is strictly liable. Also, monies paid without bankruptcy court approval are subject to disgorgement.

If a bankruptcy has been filed, the schedules and statements of financial affairs should be obtained to determine if the claim was scheduled. At times, a claim may be referenced in a bankruptcy court order and not in the schedules, hence, all bankruptcy court orders should be reviewed as well. If the claim was listed, the trustee should be contacted to determine if the claim was administered or abandoned. Remember, property remains in the estate until administered or abandoned.

Any claims that exist on the date of filing of any chapter in bankruptcy must be listed. Note that issues of nondisclosure regarding claims that accrue after the filing date, particularly in a chapter 11 or 13 bankruptcy, are more complicated and are beyond the scope of this article.

If the claim was not disclosed in the bankruptcy, attorneys for defendants should move to dismiss the case based on judicial estoppel. An attorney for a debtor should immediately contact the trustee to determine if the claim is estate property and if so, to reopen the bankruptcy to disclose the claim and have the attorney's employment approved by the bankruptcy court before an action is filed. The bankruptcy trustee may file a motion to abandon the claim.⁸ Once an order is entered abandoning the claim, the attorney is safe to proceed with representing the debtor on that claim.

Note that if a debtor is truly not aware of the claim, the case can be reopened under 11 U.S.C. §350 for administration by the trustee.

Attorneys who represent creditors should encourage any creditor to file a proof of claim if notified by the bankruptcy court to do so. At times assets are uncovered in bankruptcies well after the bankruptcy is closed. Assets recovered in bankruptcies which are not paid out to creditors are returned to debtors. Filing a proof of claim should never be considered an "exercise in futility."

IV. Conclusion

In conclusion, parties must be diligent in investigating whether a bankruptcy is involved. Judicial estoppel can be a complete defense precluding debtors and/or trustees from any recovery on claims. In the event monies have been paid on claims without bankruptcy court approval, attorneys and debtors may be required to disgorge the funds. In addition, debtors face possible denial and/or revocation of discharge and referral to the United States Attorney for bankruptcy fraud. A diligent inquiry into a plaintiff's claims should include inquiring into the plaintiff's bankruptcy history, and a simple starting point is the question "Have you ever filed for bankruptcy?"

¹ Betty Ruth Fox is an attorney at Watkins & Eager in Jackson, Mississippi.

² Please note that Diane Reed filed Petition for Rehearing En Banc on September 30, 2010. The Court has not made a decision on Ms. Reed's petition. Counsel should determine the status of the petition before citing Reed.

³ 11 U.S.C. §541.

⁴ Property of the estate also includes property acquired by the debtor within 180 days after the petition is filed by bequest, devise, or inheritance; as a result of a property settlement agreement with the debtor's spouse, or of an interlocutory or final divorce decree; or as a beneficiary of a life insurance policy or of a death benefit plan. See 11 U.S.C. §541(a)(5). In chapters 11 and 13, in which the debtor is an individual, property of the estate also includes, property the debtor acquires and earnings from services performed by the debtor after the commencement of the case but before the case is closed, dismissed, or converted to a case under chapter 7, 12, or 13. See 11 U.S.C. §§ 1115 and 1306.

⁵ 11 U.S.C. §554(d).

⁶ 11 U.S.C. §323.

⁷ 11 U.S.C. §362.

⁸ 11 U.S.C. §554 provides that "after notice and hearing, the trustee may abandon any property of the estate that is burdensome to the estate or that is of inconsequential value and benefit to the estate."

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