How To Bar Claims Not Disclosed In Bankruptcy

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Use a party's failure to adequately disclose potential litigation in bankruptcy to bar subsequent prosecution of those claims.

IT'S A COMMON SCENARIO in bankruptcy situations. A party that has filed for bankruptcy, or just emerged from it, sues someone. The defendant, giving short shrift to a vague disclosure of claims by the plaintiff, gears up to defend the action, and the machinery of another lawsuit is in motion. It doesn't have to be this way. When defending an action like this, the defendant should explore whether it has grounds to move to bar these claims because of the plaintiff's failure to adequately disclose in bankruptcy the existence or nature of the claims asserted. Courts have applied the doctrine of judicial estoppel in holding that a party's failure to ade-

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quately disclose in bankruptcy existing or potential causes of action of which it is aware estops that party from later pursuing those claims. *Krystal Cadillac-Oldsmobile GMC Truck, Inc. v. General Motors Corp.*, 337 F.3d 314 (3d Cir. 2003); *In re Coastal Plains, Inc.*, 179 F.3d 197 (5th Cir. 1999), *cert. denied*, 528 U.S. 1117 (2000); *Payless Wholesale Distribs. v. Culver*, 989 F.2d 570 (1st Cir. 1993), *cert. denied*, 510 U.S. 931 (1993). This duty to "adequately disclose" requires a party to disclose in bankruptcy the existence of a claim, as well as the nature and value of the claim, if known, and may not be satisfied by general "boilerplate language" regarding a potential dispute. *Krystal*, supra, 337 F.3d at 321.

THE DUTY TO "ADEQUATELY DISCLOSE" POTENTIAL LITIGATION IN BANKRUPTCY • Under the Bankruptcy Code, a debtor is required to "file a…schedule of assets and liabilities…and a statement of the debtor's financial affairs. …" 11 U.S.C. §521(1). Moreover, a debtor must file a disclosure statement containing "adequate information." 11 U.S.C. §1125(b). A party in bankruptcy has an affirmative duty to disclose "all property of the estate" including any causes of action it may have. *Krystal*, supra, 337 F.3d at 321 n.5. "The Code requires that a debtor list potential causes of action, not claims it actually intends to sue on at the time of the required disclosure. 'It has been held that a debtor must disclose any litigation likely to arise in a non-bankruptcy context.'" *Id., quoting Oneida Motor Freight, Inc. v. United Jersey Bank*, 848 F.2d 414, 417 (3d Cir. 1988), *cert denied*, 488 U.S. 967 (1988). The duty of disclosure in a bankruptcy proceeding is a continuing one. *In re Coastal Plains*, supra, 179 F.3d at 208.

BARRING CLAIMS NOT ADEQUATELY DISCLOSED IN BANKRUPTCY • If a party fails to adequately disclose a cause of action in bankruptcy the doctrine of judicial estoppel may bar later prosecution of those claims. For judicial estoppel to bar these subsequent claims, a defendant must establish three factors:

- That the party to be estopped has "taken two positions that are irreconcilably inconsistent";
- That the party has changed his or her position "in bad faith"; and
- That dismissal is "'tailored to address the harm identified' and no lesser sanction would adequately remedy the damage done by the litigant's misconduct."

Krystal supra, 337 F.3d at 319-320, *quoting Montrose Medical Group Participating Savings Plan v. Bulger*, 243 F.3d 773, 779-80 (3rd Cir. 2001).

ESTABLISHING THAT A PARTY HAS TAKEN TWO IRRECONCILABLY INCONSISTENT POSITIONS • To establish that a party has taken a position in bankruptcy that is irreconcilably inconsistent to the claims being asserted, a defendant must establish that the party knew about the claims now being asserted at the time of the bankruptcy. *Krystal*, 337 F.3d 314. A defendant need not establish that the debtor knew all the facts or even the legal basis for the cause of action; rather, if defendant can establish

that the debtor had "enough information before confirmation to suggest that it may have a possible cause of action, then that is a 'known' cause of action such that it must be disclosed." *In re Coastal Plains, Inc.*, supra, 179 F.3d at 208 (quotations omitted). If a party asserting a claim knew about the claim during its bankruptcy, but fails to disclose the claim, a party is deemed to have taken "two positions that are irreconcilably inconsistent." *Krystal* supra, 337 F.3d at 319.

Lack Of Specificity

In addition, a representation may be deemed inconsistent for purposes of application of judicial estoppel in the bankruptcy context (even if the debtor disclosed a dispute with the defendant), when the debtor failed to describe this dispute with sufficient specificity. *Id.* at 320-321. For example, in *Krystal*, plaintiff contended that it had sufficiently disclosed the claims it was attempting to assert against General Motors because it had noted in its Disclosure Statement filed during the bankruptcy proceeding that the status of its Automobile Franchise Agreement with General Motors was in litigation. *Id.* The Court rejected this argument stating that "the language in the Amended Disclosure Statement was 'little more than boilerplate.' It did not specify any of the claims contained in the instant complaint against GM, much less attempt to place any monetary value on them. …[S]uch boilerplate language is simply not adequate to provide the level of notice required." *Krystal, Id.* at 321. As such, in addition to analyzing whether a party has a basis to seek to bar claims that were not disclosed at all in bankruptcy, a party should also analyze whether they have a basis to seek to bar claims that were not disclosed in adequate detail.

Making The Discovery

Accordingly, as discovery proceeds, a defendant should first determine if the claims being asserted were disclosed during bankruptcy. This can be determined through careful review of the schedules of assets and liabilities, the statement of financial affairs, and the disclosure statement which a debtor is required to file pursuant to 11 U.S.C. §§521 and 1125. Defendant should next seek to determine the date plaintiff first knew of the facts underlying the claims now being asserted. If this cannot be established from the complaint or bankruptcy filings, interrogatories, or targeted questions at a deposition should be utilized to ascertain this information. By comparing the statements or omissions previously made in bankruptcy, with the statements made in the subsequent litigation, a party can establish the knowledge necessary to prove that the two positions are irreconcilably inconsistent.

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ESTABLISHING BAD FAITH • To establish the second element necessary for the application of judicial estoppel in this context, a party must prove that the litigant is now taking a contrary position "in bad faith." *Krystal,* 337 F.3d 319-20 (*quoting Montrose,* 243 F.3d at 779-80). If the failure to disclose assets in bankruptcy was "inadvertent," judicial estoppel will not bar the claims subsequently asserted. *In re Coastal Plains, Inc.*, supra, 179 F.3d at 210, n.9 (compiling cases).

There does not appear to be any set standard that is applied to determine when dismissal of a claim is appropriate as opposed to some lesser sanction.

Inadvertence Difficult To Demonstrate

A "debtor's failure to satisfy its statutory disclosure duty is 'inadvertent' only when, in general, the debtor either lacks knowledge of the undisclosed claims or has no motive for their concealment." *Id.* at 210. It has been held that "a rebuttable inference of bad faith arises when averments in the pleadings demonstrate both knowledge of a claim and a motive to conceal that claim in the face of an affirmative duty to disclose." *Krystal*, supra, 337 F.3d at 321. It is not necessary to show that the party actually benefited from the representations in order for judicial estoppel to bar the later asserted claims. *Id.* at 324 ("[T]he application of judicial estoppel does not turn on whether the estopped party actually benefited from its attempt to play fast and loose with the court").

Motive To Conceal

While knowledge of the undisclosed claims can be established through comparison of statements made in the two proceedings as discussed above, courts have found motive to conceal to exist when disclosure of the claims may have resulted in creditors taking different actions in the bankruptcy with regard to disposition of assets or approval of the bankruptcy plan and where the debtor has the potential to benefit from the non-disclosure. *See In re Coastal Plains,* supra, 179 F.3d at 212-13 (motive to conceal found where creditors might have opposed lifting stay if claims disclosed, or may have bid on claims); *Krystal,* 337 F.3d at 323-24 (motive to conceal found when creditors agreed to negotiate down the amount received for claims); *Payless Wholesale Distribs., Inc.,* supra, 989 F.2d at 571 (motive to conceal found when debtor obtained release of creditors' claims on representation that no additional assets existed). Other courts have found that bad faith was not present where the failure to list potential litigation was offset by the failure to list corresponding liabilities and creditors; there was no evidence that disclosure would have played any role in the confirmation of the plan of reorganization; and where there was no evidence that the party derived or intended any appreciable benefit from the non-disclosure. *See Ryan Operations, G.P. v. Santiam-Midwest Lumber Co.*, 81 F.3d 355, 363-64 (3d Cir. 1996).

To establish a party's "motive to conceal," a party should review the procedural posture of the bankruptcy to determine if the court or creditors have taken or acquiesced in certain actions that they might not otherwise have, based on the representations made during the bankruptcy. *See Krystal,* supra, 337 F.3d at 324-25; *In re Coastal Plains,* 179 F.3d at 212-13; *Payless Wholesale Distribs., Inc.,* supra, 989 F.2d at 571. In addition, a party should review the bankruptcy filings to *determine* whether these filings contain language allowing causes of action or undistributed assets to revert back to the debtor upon completion of the bankruptcy. While a defendant need not show that the party actually benefited from its misrepresentations, such language can bolster the argument that the debtor was attempting to "[c]onceal [its] claims; get rid of [its] creditors on the cheap, and start over with a bundle of rights." *Id.*

ESTABLISHING THAT DISMISSAL IS THE APPROPRIATE SANCTION • There does not

appear to be any set standard that is applied to determine when dismissal of a claim is appropriate as opposed to some lesser sanction. However, it has been held that dismissal is appropriate if the non-disclosing party has the potential to benefit from its omission through application of a lesser sanction, such as requiring that creditors be paid out of any recovery. *Krystal*, supra, 337 F.3d 325. Dismissal is the appropriate sanction because any lesser sanction would send a message that "a debtor should consider disclosing potential assets only if he is caught concealing them." *Id.* (citation omitted).

CONCLUSION • Through careful review of required bankruptcy filings, and targeted follow-up discovery, a defendant can potentially use a party's failure to adequately disclose litigation as a means to exclude the claims asserted.

PRACTICE CHECKLIST FOR
How To Bar Claims Not Disclosed In Bankruptcy

When defending claims brought by a plaintiff that has filed for or recently exited bankruptcy, the following are among the steps a party should take to determine whether it has grounds to bar these claims because of the plaintiff's failure to adequately disclose in bankruptcy the existence or nature of the claims asserted.

- Review all bankruptcy filings for statements or omissions regarding the claims being asserted.

- Compare the statements made in the bankruptcy proceeding to those made in the subsequent litigation to establish inconsistencies.

- Establish the date that the plaintiff first knew of the facts underlying the claims now being asserted through careful review of the bankruptcy filings and the complaint filed in the subsequent action, and if necessary, conduct targeted follow-up discovery.

- Review bankruptcy filings for language which would indicate motive to conceal the claims and the procedural history of the bankruptcy to establish reliance by the court or creditors on the statements made in bankruptcy.