

# Recurring Issues in the Prosecution of Employment Claims in a Bankruptcy

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**E**mployees who lose their jobs often find themselves in strained financial circumstances. They may believe they have a claim against their employer in connection with their termination. Because of this, issues relating to employment claims arise frequently in bankruptcies. Does an employment claim need to be disclosed in a bankruptcy filing? Does the automatic stay apply? Who has standing to prosecute the claim or the authority to settle the claim? This article addresses these and several other frequently-encountered issues.

## **The debtor must list the employment claim in her schedule of assets**

The Bankruptcy Code<sup>1</sup> provides that the bankruptcy estate consists, with very narrow exceptions, of “all legal or equitable interests of the debtor in property as of the commencement of the case.”<sup>2</sup> Accordingly, any employment-related claim that exists as of the bankruptcy petition date would almost certainly be part of a debtor’s bankruptcy case.<sup>3</sup>

The debtor must file, at or shortly after the beginning of the bankruptcy case, a schedule of assets. There is an official form for this purpose, which makes clear that debtors must disclose “contingent and unliquidated claims of every nature . . .”<sup>4</sup> “The integrity of the bankruptcy system relies on full disclosure of all assets, including potential but unlitigated claims.”<sup>5</sup> Thus, employment-related claims must be scheduled. All debtors must amend their schedules to add a prepetition claim which they previously failed to list. And for chapter 11 bankruptcies (“Reorga-

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nization”) and chapter 13 bankruptcies (“Adjustment of Debts of an Individual with Regular Income”) the bankruptcy estate includes post-petition assets, arguably obligating the debtor to schedule these post-petition assets.

Notwithstanding these straightforward and fundamental requirements, there is a surprisingly large volume of case law involving debtors who have failed to disclose employment-related causes of action in their schedule of assets.

## **The automatic stay will not generally apply if the claim belongs to the bankruptcy estate**

Generally speaking, the automatic stay of Bankruptcy Code section 362 only applies to actions *against* the debtor, not to actions initiated by the debtor. Therefore, if the debtor’s bankruptcy estate owns an employment claim, the automatic stay will not prevent the bankruptcy trustee or debtor in possession from continuing to prosecute that claim. Nor does the stay prevent a defendant from protecting its interest in claims brought by the debtor, even if defendant’s successful defense will result in the loss of an allegedly valua-

ble employment claim asserted by the estate.<sup>6</sup> In other words, an employer can seemingly obtain a dismissal of the claim belonging to the employee’s bankruptcy estate without violating the stay.<sup>7</sup>

## **Who has standing to prosecute the employment claim?**

In a chapter 7 case, only the chapter 7 trustee has standing to prosecute the debtor’s prepetition employment claims.<sup>8</sup>

In a chapter 11 case, the debtor-in-possession has standing to prosecute the debtor’s prepetition and post-petition employment claims. If a chapter 11 trustee is appointed, then the “debtor in possession” becomes a mere “debtor,” and control of the estate passes to the trustee. The chapter 11 trustee would thereafter have standing to prosecute any such claims.

With respect to a chapter 13 case, while the law in the Ninth Circuit is not entirely clear, the extant law suggests that a chapter 13 debtor retains standing to prosecute her prepetition and post-petition employment claims.<sup>9</sup>

## Judicial estoppel may bar a debtor's attempt to prosecute an unscheduled claim

There is much case law involving a debtor suing on a prepetition employment claim that she failed to disclose in her schedule of assets. Defendants who find themselves subject to an employment claim brought by a debtor, but which was not disclosed in the debtor's schedule of assets, invariably assert a judicial estoppel defense. The essence of such a defense is that the debtor is precluded from prosecuting a claim in a non-bankruptcy forum that he did not disclose to the bankruptcy court. If a defendant finds himself in federal court, the leading statement of the bankruptcy judicial estoppel defense in the Ninth Circuit is *Hamilton v. State Farm Fire & Cas. Co.*<sup>10</sup> If the defendant finds himself in Idaho state court, the leading bankruptcy judicial estoppel case appears to be *McCallister v. Dixon*.<sup>11</sup>

Four factors typically seem to control the analysis. A court will examine whether the claimant's later position (that she possesses an employment claim) is "clearly inconsistent" with her earlier position (the position taken in her bankruptcy schedules that no claim exists). A second factor is whether the party has succeeded in persuading a court to adopt the claimant's earlier position, so that a judicial acceptance of an inconsistent position in the later proceeding would create the perception that one of the courts was misled. Third, courts will often look at whether the party seeking to assert an inconsistent position would derive an unfair advantage or impose an unfair detriment on the opposing party if not estopped.<sup>12</sup> Fourth, the court might consider whether the omission was mistaken or inadvertent.<sup>13</sup>

The most sensible result would be to permit the prosecution of the claim with conditions to ensure that the claim is pursued in a way that ensures that the bankruptcy estate, and not the debtor herself, realizes the benefits of recovery. The bankruptcy trustee would argue that an employer who has committed an actionable wrong should not be relieved of responsibility merely because the debtor tried to hide the claim from his creditors. And indeed, it appears that this may be what most often happens.

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## The debtor faces other penalties for failing to disclose an employment claim

Judicial estoppel is not the only potential defense available when a previously undisclosed employment claim comes to light.

Dishonesty in a bankruptcy proceeding is a federal criminal offense. Section 152 of title 18 of the U.S. Code prohibits a debtor from "knowingly and fraudulently" concealing assets of the bankruptcy estate or making a false oath in a bankruptcy case, among other things. Section 157 of title 18 of the U.S. Code criminalizes, among other things, fraudulent conduct in a bankruptcy case. Both statutes provide for fines and imprisonment not to exceed five years for each prohibited offense.

Debtors can also face civil sanctions in the bankruptcy case. Section 727 of the Bankruptcy Code provides that the debtor shall be denied his discharge if he engages in certain wrongful conduct, such as transferring or concealing his property in the year prior to the filing of the petition, or concealing property of the bankruptcy estate, in an attempt to defraud creditors.

*In re Couch-Russell*<sup>xvi</sup> concerned a debtor's apparently-purposeful failure to disclose a prepetition employment claim. The chapter 13 debtor prosecuted a prepetition sexual harassment claim against her ex-employer during her bankruptcy case but failed to disclose the existence of the claim in her schedule of assets. The defendant ultimately discovered the failure to disclose. The debtor ended up dismissing her chapter 13 bankruptcy case, without obtaining a discharge, as a means to avoid sharing the employment claim's settlement value with her creditors. She settled the employment claim for

The Idaho Supreme Court recently affirmed a trial court's forced substitution of a chapter 13 trustee for the debtor in a state court (non-employment) tort lawsuit when it came to light, quite late in the litigation, that the claim at issue should have been scheduled but was not.<sup>14</sup> The bankruptcy case was reopened so that the trustee could prosecute the claim. This same result occurred with respect to an employment claim in *In re Hall*, a bankruptcy case.<sup>15</sup> Another route to the same result occurred in *Donato v. Metropolitan Life*.<sup>16</sup>

\$30,000 almost contemporaneously with the dismissal of her bankruptcy case. She then promptly spent the settlement funds, and filed a second bankruptcy case seven months later.

The bankruptcy court denied the debtor a discharge in her second bankruptcy on the grounds that debtor had transferred her property — the settlement proceeds — within a year of the second petition date in an attempt to defraud her creditors. In finding fraudulent intent, the bankruptcy court relied in part on the debtor's culpable conduct in the first bankruptcy case.

A second Idaho debtor who failed to disclose his claim in his chapter 13 case nonetheless did manage to escape with discharge intact. Jerry Doherty was the non-disclosing debtor in the Idaho Supreme Court case *McCallister v. Dixon*.<sup>17</sup> Further research in the bankruptcy docket in Mr. Doherty's bankruptcy case reveals that the bankruptcy trustee agreed not to prosecute her motion to vacate the debtor's already-granted discharge in his bankruptcy case in exchange for Mr. Doherty's agreement to cooperate with the trustee's prosecution of his claim.<sup>18</sup>

### **The claim is likely not exempt**

Exempt assets are the assets that the debtor need not make available to his creditors even though they are assets of the bankruptcy estate. In Idaho, a debtor in bankruptcy can utilize only those exemptions provided for by Idaho non-bankruptcy law.<sup>19</sup> Generally speaking, Idaho law contains no exemptions for employment-related claims, except to the extent certain claims may be exempt under ERISA. Although claims for wrongs such as sexual harassment or discrimination would seem to be "personal" in nature, such claims do not appear to be exempt.

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The court must determine whether the settlement is "fair and equitable" and "reasonable" by applying these criteria:

Debtors, unsurprisingly, do on occasion try to claim an exemption in their employment claims so they can keep the proceeds for themselves. In *In re Lee*,<sup>20</sup> for example, the debtor claimed an exemption in the proceeds of her lawsuit against her employer for wrongful discharge and sexual harassment. The debtor claimed that the proceeds were exempt under I.C. § 11-604(1)(c) as "proceeds of . . . a settlement . . . accruing as a result of bodily injury . . .".

The bankruptcy court in *Lee*, however, held that the wrongful discharge claim was akin to a breach of contract claim, and section 11-604(1)(c) did not apply. The court likewise rejected the contention that the sexual harassment claim involved "bodily injury" in light of the absence of evidence of an actual physical injury. The court concluded that the debtor's contention that she suffered emotional distress from the harassment was not sufficient.

### **Settlements involving the bankruptcy estate must be approved by the bankruptcy court**

Regardless of whether the bankruptcy case is pending under chapter 7, chapter 11, or chapter 13, settlements involving the bankruptcy es-

tate must almost always be approved by the bankruptcy court.<sup>21</sup>

In the Ninth Circuit, the bankruptcy court must evaluate the settlement under a test widely called the "A & C Properties" test.<sup>22</sup> The court must determine whether the settlement is "fair and equitable" and "reasonable" by applying these criteria:

- the probability of success in the litigation.
- the difficulties to be encountered in the matter of collection;
- the complexity of the litigation involved, and the expense, inconvenience and delay necessarily attending it; and
- the paramount interest of the creditors and a proper deference to their reasonable views in the premises.<sup>23</sup>

The trustee (or the debtor in possession) bears the burden of proving that the settlement is reasonable, but he need not prove the estate has reached the best possible deal. Instead, he needs only to prove that the settlement falls above the lowest point in the range of reasonableness.<sup>24</sup>

### **Settlements with the trustee probably cannot be kept confidential**

Employers who pay to settle em-

ployment-related claims typically prefer to keep the terms of settlement confidential. Employers do not want their current litigation adversaries, their current employees, or the plaintiffs' bar to know what the employer is paying to settle claims.

However, it seems improbable that an employer could successfully shield the terms of its settlement with a bankruptcy estate from public disclosure. The Bankruptcy Code<sup>25</sup> and the Bankruptcy Rules<sup>26</sup> do contain provisions permitting the sealing of court filings where necessary. But, public disclosure and notice in bankruptcy cases are highly valued. Creditors would not be able to evaluate a proposed settlement if key details were not disclosed. Indeed, recent case law from our district suggests that an employer who wishes to withhold the details of a proposed settlement from the public record faces a nearly-impossible task.<sup>27</sup>

## Endnotes

1. The Bankruptcy Code is found at title 11 of the United States Code, section 541(a)(1).
2. 11 U.S.C. § 541(a)(1).
3. 11 U.S.C. §§ 1115,1306.
4. Official Bankruptcy Form 6B, ¶ 21.
5. *Arruda v. C & H Sugar Co.*, 2007 WL 754627, at \*7 (E.D. Cal. Mar. 8, 2007).
6. *Linares v. CitiMortgage, Inc.*, 2015 WL 2088705 at \*4 (N.D. Cal. May 5, 2015) (citing *Palmdale Hills Prop., LLC v. Lehman Commercial Paper, Inc.* (*In re Palmdale Hills Prop., LLC*), 654 F.3d 868, 875 (9th Cir. 2011)).
7. *White v. City of Santee* (*In re White*), 186 B.R. 700 (9th Cir. BAP 1995). See also *Gordon v. Whitmore* (*In re Merrick*), 175 B.R. 333 (9th Cir. BAP 1994). But see *In re Gregg*, 00.1 IBCR 42 (Bankr. D. Idaho 2000) (Bankruptcy court suggests in dicta that section 362(a)(3) might prevent a non-bankruptcy court from entering a judgment that "exercise[s] control over property of the estate" by, for example, dismissing the claim.)

8. In *In re Clark*, 2012 WL 12261414 (Bankr. D. Ariz. Apr. 24, 2012), the bankruptcy court seemed unconcerned that the trustee's settlement with the debtor's former employer might be a "death knell" for the debtor's career in the securities industry, in light of the fact that the settlement was financially beneficial to the estate.

9. See *In re DiSalvo*, 219 F.3d 1035, 1039 (9th Cir. 2000); *Linares v. CitiMortgage, Inc.*, 2015 WL 2088705, at \*5, 6; *Donato v. Metro. Life Ins. Co.*, 230 B.R. 418 (N.D. Cal. 1999).

10. 270 F.3d 778 (9th Cir. 2001). See also Pamela Foohey, *Recent Developments in Judicial Estoppel and Dismissal of Employment Discrimination Suits*, 29-10 ABIJ 20, 74-75 (2010).

11. 154 Idaho 891, 303 P.2d 578 (2013).

12. *Hamilton v. State Farm*, 270 F.3d at 782-83.

13. *Ah Quin v. County of Kauai Dep't of Transp.*, 733 F.3d 267, 279 (9th Cir. 2013).

14. *McCallister v. Dixon*, 154 Idaho 891, 303 P.3d 578.

15. 02.4 IBCR 181 (Bankr. D. Idaho 2002). "IBCR" is the Idaho Bankruptcy Court Reporter, published by Goller Publishing.

16. 230 B.R. 418.

17. 154 Idaho 891, 303 P.2d 578

18. "Order," docket no. 64, *In re Doherty*, Case No. 05-41630, United States Bankruptcy Court, District of Idaho, April 26, 2012. Mr. Doherty's claim was a tort claim, but the same rationale would have applied to an employment claim.

19. Idaho Code § 11-609.

20. 96.2 IBCR 84 (Bankr. D. Idaho 1996).

21. *Woodson v. Fireman's Fund Ins. Co.* (*In*

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*re Woodson*), 839 F.2d 610, 619 (9th Cir. 1988).

22. *Martin v. Kane* (*In re A & C Props.*), 784 F.2d 1377, 1380 (9th Cir. 1986).

23. *Id.* at 1381

24. *In re Clark*, 2012 WL 12261414, at \*4.

25. 11 U.S.C. § 107.

26. Fed. R. Bankr. Pro. 9018.

27. *In re Apply 2 Save, Inc.*, 11.2 IBCR 67 (Bankr. D. Idaho 2011). This case does not involve an employment claim, but its rationale would apply equally to employment claims.

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