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JUDICIAL ESTOPPEL CAN BAR A FORMER DEBTOR FROM RECOVERING FOR MERITORIOUS LITIGATION CLAIMS

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When a defendant faces claims by a plaintiff that recently emerged from bankruptcy, there is a potential basis to reduce the plaintiff's recovery to zero, regardless of whether the plaintiff has a slam-dunk liability case that would otherwise yield millions of dollars in damages.

Judicial estoppel is the long-standing judicial principle that "prevents a party from asserting a claim in a legal proceeding that is inconsistent with a claim taken by that party . . . in a previous proceeding." 18 Bender, Moore's Federal Practice (3d ed. 2000) § 134.30, pp. 134–62. In the bankruptcy context, the Bankruptcy Code requires a debtor to disclose *all* of his or her assets. Importantly, this disclosure must include all of the debtor's known litigation claims, even those not yet asserted in court, because those litigation claims have the potential to enhance the value of the bankruptcy estate and thus have at least some current value. A debtor that does not disclose a potential litigation claim during the course of its bankruptcy represents to the Bankruptcy Court and his or her creditors that no such claim exists. Consequently, when a debtor later pursues a claim that was not disclosed during the bankruptcy proceedings, the debtor takes the exact opposite position—*i.e.*, that those claims *do* in fact exist. It is under these circumstances that the traditional principles of judicial estoppel can bar the debtor from receiving any benefit at all—even a single dollar—based on those concealed claims, regardless of the merit or value of those claims.

Many defendants, who often are complete strangers to the plaintiff's bankruptcy, are completely unaware of this potentially case-dispositive defense.

Every Debtor Must Disclose Its Potential Litigation Claims

The Bankruptcy Code requires a debtor to disclose all of the estate's property and assets. Because litigation claims are assets of the estate, when filing a bankruptcy petition, the debtor must list all "causes of action against third parties (whether or not a lawsuit has been filed)," and "[o]ther contingent and unliquidated claims or causes of action of every nature, including counterclaims of the debtor and rights to set off claims." Official Form 206A/B (for non-individuals); *see also* Official Form 106A/B (same requirement for individuals). This disclosure requirement is triggered by the debtor's knowledge of "material facts surrounding the [claim]," regardless of the debtor's knowledge of the Bankruptcy Code. *See Hamilton v. State Farm Fire & Cas. Co.*, 270 F.3d 778, 784–85 (9th Cir. 2001).

When a Bankruptcy Court confirms a plan of reorganization, it relies on the debtor's representations to the Court and creditors that all of the debtor's assets have been disclosed, including all potential claims against third parties. Courts often note that "the integrity of the bankruptcy system depends on full and honest disclosure by debtors of all their assets." *See, e.g.*, *In re Coastal Plains, Inc.*, 179 F.3d 197, 208 (5th Cir. 1999) (emphasis omitted). To protect the integrity of the bankruptcy system, courts can invoke the doctrine of judicial estoppel to "wip[e]

out a potentially meritorious action" when the lawsuit is based on claims that were previously concealed from a Bankruptcy Court. *Ah Quin v. Cnty. of Kauai Dep't of Transp.*, 733 F.3d 267, 273 (9th Cir. 2013).

The Supreme Court has established a three-part test to assess whether judicial estoppel should be applied: (1) the party must be advancing a legal position which is "clearly inconsistent" with its earlier position; (2) a court must have accepted the initial position; and (3) the party would "derive an unfair advantage or impose an unfair detriment on the opposing party if not estopped." *New Hampshire v. Maine*, 532 U.S. 742, 743 (2001).

The Ninth Circuit has held that non-disclosure of potential litigation claims generally warrants application of judicial estoppel. First, courts treat a failure to disclose a claim on a bankruptcy schedule as a representation that the claim does *not* exist. When a debtor later pursues the claim, he or she effectively takes the contrary position that the claim *does* exist. *See Ah Quin*, 733 F.3d at 271. Second, when the Bankruptcy Court confirms a reorganization or repayment plan, it "accept[s]" the plaintiff-debtor's legal position. *Id.* Finally, the Ninth Circuit has noted that there are several ways to receive an "unfair advantage" in the bankruptcy context, including by inducing the Bankruptcy Court to confirm a plan or grant a final discharge without allocating all estate assets to the stakeholders. *See id.*; *Hamilton*, 270 F.3d at 784.

Plaintiffs Can Argue Judicial Estoppel Does Not Apply Even If All Three Factors Are Met

Judicial estoppel is not absolute. Following the Supreme Court's decision in *New Hampshire v. Maine*, the Ninth Circuit in *Ah Quin* recognized an exception to judicial estoppel when "a party's prior position was based on inadvertence or mistake." 733 F.3d at 271 (internal quotation marks omitted). Parties often attempt to correct their prior "mistake" by reopening their bankruptcy case to disclose the claim in an amended schedule. The Ninth Circuit has, in some cases, applied a more lenient standard to a plaintiff-debtor that remedies the non-disclosure *before* a defendant raises judicial estoppel as a defense. *See id*. at 278.

The "Inadvertence Or Mistake" Exception For Never-Disclosed Claims

If a plaintiff-debtor declines to reopen bankruptcy proceedings and fails to amend his or her bankruptcy schedules to include the previously undisclosed claims, then the "inadvertence or mistake" defense is "a narrow exception." *See id.* at 271–72. When a court applies the inadvertence or mistake exception narrowly (as opposed to applying the broader common meaning of inadvertence or mistake), the court presumes that the plaintiff-debtor intentionally deceived the Bankruptcy Court and that the plaintiff-debtor "knew about the claim when he or she filed the bankruptcy schedules." *Id*. at 271. Courts have noted that debtors "nearly always" have a motive to conceal claims from the Bankruptcy Court because concealment can "keep[] any potential proceeds from creditors." *Id*. at 271–72. Put simply, if a debtor takes no action to correct its mistake, the Ninth Circuit presumes deceit and it is exceedingly difficult to overcome the "default rule" that judicial estoppel bars undisclosed claims. *See id.* ("[T]he federal courts have developed a basic default rule: If a plaintiff-debtor omits a pending . . . lawsuit from the bankruptcy schedules and obtains a discharge . . . , judicial estoppel bars the action.").

The "Inadvertence Or Mistake" Exception For Later-Disclosed Claims

When a plaintiff-debtor amends his or her bankruptcy schedules to include previously undisclosed claims, the Ninth Circuit interprets "inadvertence" and "mistake" according to the common understanding of those terms. *Ah Quin*, 733 F.3d at 276–77 (declining to follow other circuits which apply the narrow standard of "inadvertence or mistake" to all cases). Under this more lenient standard, the relevant inquiry focuses on "the plaintiff's subjective intent when filling out and signing the bankruptcy schedules." *Id*. Two important factors to this inquiry are: (1) whether the plaintiff-debtor submitted an affidavit that adequately explains the omission as inadvertent or mistaken; and (2) whether the bankruptcy schedule was amended before or after the defendant raised judicial estoppel as a defense. *See Dzakula v. McHugh*, 746 F.3d 399, 401–02 (9th Cir. 2014).

- **The Affidavit.** The Ninth Circuit's "subjective intent" test for the defense often turns on the plaintiff-debtor's affidavit explaining the reason for the omission—*i.e.*, the debtor's subjective intent. If a plaintiff-debtor does not submit an affidavit explaining why he or she omitted pending claims from the bankruptcy schedules, courts are more likely to reject claims of inadvertence or mistake. If the plaintiff-debtor does submit such an affidavit, however, courts often treat intent as an issue of fact unless the affidavit is "blatantly contradicted by the record." *Ah Quin*, 733 F.3d at 278 (internal quotation marks omitted). Therefore, when a plaintiff-debtor both amends his or her bankruptcy schedule and submits an uncontroverted affidavit claiming the original omission was inadvertent or mistaken, the court is less likely to bar

the claims as a matter of law. *See id.* at 277–79; *see also In re Plise*, 719 F. App'x 622, 624–25 (9th Cir. 2018); *Locke v. Wells Fargo Bank*, No. 2:19-cv-08854-ODW, 2020 WL 3546069, at *4–5 (C.D. Cal. June 30, 2020).

• **Timing Of The Disclosure.** Second, the timing of when the plaintiff-debtor amends his or her bankruptcy schedule is a relevant factor. When a plaintiff-debtor amends *before* a defendant raises judicial estoppel as a defense, courts treat this action as evidence that the omission truly was inadvertent. On the other hand, if the plaintiff-debtor only amends his or her bankruptcy schedules *after* the defendant raises judicial estoppel, it is more likely that a court applies judicial estoppel because the "timing of the reopening of the bankruptcy case seems inculpatory," rather than an honest correction of a mistake. *Ah Quin*, 733 F.3d at 278; *see Cannon-Stokes v. Potter*, 453 F.3d 446, 448 (7th Cir. 2006) ("[I]f [plaintiff-debtor] were really making an honest attempt to pay her debts, then as soon as she realized that [the claim] *had* been omitted, she would have filed amended schedules and moved to reopen the bankruptcy, so that the creditors could benefit from any recovery.").

Application Of Judicial Estoppel In The Ninth Circuit

The leading Ninth Circuit case applying judicial estoppel stemming from bankruptcy proceedings, *Ah Quin v. County Of Kauai Department of Transportation*, applied the doctrine to a plaintiff who disclosed her claims after judicial estoppel was raised. 733 F.3d 269. In *Ah Quin*, the plaintiff filed for bankruptcy while litigation against her former employer was pending. *Id*. The plaintiff failed to list the employment lawsuit as an asset on her bankruptcy schedule and, after standard bankruptcy proceedings, the Bankruptcy Court (still unaware of the debtor's employment lawsuit) issued a discharge and closed the cased. *Id*. When the plaintiff's counsel in the employment litigation learned about the bankruptcy non-disclosure, she promptly notified the defendant and claimed that the non-disclosure was a mistake stemming from the "vague" wording in the bankruptcy paperwork. *Id.* at 270, 276–77. The defendant immediately notified the district court of its intention to raise judicial estoppel as a defense. *Id*. at 269–70, 278. In response, the plaintiff reopened the bankruptcy case and amended her schedules to include the discrimination lawsuit. *Id*. at 270. Nevertheless, the district court found that the plaintiff was estopped, granted summary judgment, and dismissed the case. *Id*.

The plaintiff's appeal to the Ninth Circuit was grounded in the district court's interpretation of the "inadvertence or mistake" exception. The district court in *Ah Quin* applied the Tenth Circuit's rule that a failure to disclose "is inadvertent or mistaken 'only when . . . the debtor either lacks knowledge of the undisclosed claims or has no motive for their concealment.'" *See Ah Quin v. Cnty. of Kauai Dep't of Transp.,* 433 B.R. 320, 324–25 (D. Haw. 2010) (quoting *Eastman v. Union Pac. R.R. Co.*, 493 F.3d 1151, 1157 (10th Cir. 2007)). The district court, noting the plaintiff's knowledge of the claims and inherent financial motive to conceal them from her creditors, declined to engage in further fact finding and granted summary judgment for the defendant. *See id.* at 325.

The Ninth Circuit discussed whether to adopt the Tenth Circuit rule, and in doing so grappled with debtors' incentives to disclose assets during a bankruptcy case. The Ninth Circuit began by acknowledging that "full disclosure in bankruptcy proceedings 'cannot be overemphasized'" and is "essential to the functioning of the bankruptcy system." *Ah Quin*, 773 F.3d at 271–73. However, the court rejected the argument that strict application of judicial estoppel is always appropriate to deter plaintiff-debtors from lackadaisical or fraudulent accounting of assets. *Id*. at 273.[1]

The Ninth Circuit noted that when a bankruptcy case is reopened to accurately list the debtor's assets, the second and third prongs of the *New Hampshire* test might be reversed. *Id*. at 274. When disclosures are accurate, the Bankruptcy Court knows that the previously undisclosed claim exists, and the debtor has lost his or her unfair advantage by ceding the litigation claim for creditors to recover. *Id*. The court further noted that the bankruptcy system already provides strong incentives to disclose, given that a plaintiff-debtor could face civil or criminal penalties for non-disclosure. *Id.* at 275. Invoking these justifications, the court declined to follow other circuits in presuming deceit in all cases where a debtor initially fails to disclose claims to the Bankruptcy Court. *Id*. at 276–77. Instead, the court held that the inadvertence or mistake defense is interpreted broadly or narrowly depending on whether the plaintiff-debtor ultimately discloses the claims to the Bankruptcy Court. *Id*. at 277. Since *Ah Quin* eventually disclosed her claims to the Bankruptcy Court, the Ninth Circuit remanded the case for additional fact finding about whether she had subjective intent to conceal the claim, and the parties ultimately settled before the district court could issue a ruling on remand. *See id.* at 278–79.

Impact Of Judicial Estoppel On Debtors And Creditors

Judicial estoppel is a uniquely powerful doctrine. It can "wip[e] out a potentially meritorious action against an unrelated third party" due to the plaintiff's prior representation to a prior court, even though that false representation may not have prejudiced the defendant. *Ah Quin*, 733 F.3d at 273.

But what about the plaintiff-debtor's creditors that were deprived of their opportunity to recover on account of the debtor's litigation claims? Some courts have held that even if judicial estoppel bars the plaintiff-debtor from recovering, a trustee can be appointed to pursue the estopped claims for the benefit of the innocent creditors. *See id.*; *Weinstein v. AutoZoners LLC*, No. 2:11-CV-00591-LDG, 2014 WL 898081, at *9 (D. Nev. Mar. 6, 2014).

However, even if a trustee were permitted to pursue the claims for the benefit of creditors, judicial estoppel could nonetheless limit the defendant's exposure to only the amount owed to creditors, because no additional money can be paid to the plaintiff who is barred from receiving any recovery. For example, a defendant that may otherwise be facing $1 billion in asserted damages may be able to limit its exposure to the millions (or less) that the creditors were shorted in the bankruptcy. In this circumstance, judicial estoppel would still represent a significant victory for a defendant.

Conclusion

Judicial estoppel is a powerful doctrine that can prevent a plaintiff from recovering even if the plaintiff's claims are meritorious.

When defending claims against a plaintiff that has recently emerged from bankruptcy, check whether the claims asserted against your client were ever disclosed. And if you are asserting claims on behalf of a client who recently emerged from bankruptcy, ensure that the claims you are pursuing were properly disclosed to the Bankruptcy Court before the defendant beats you to the punch and blunts your inadvertence defense by raising judicial estoppel first.

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[1]There is currently a split in authority regarding the inadvertence or mistake exception. The Tenth and Fifth Circuits use the stricter rule. See Allen v. C & H Distributors, L.L.C., 813 F.3d 566, 573–74 (5th Cir. 2015); Anderson v. Seven Falls Company, 696 F. App'x. 341, 348 (10th Cir. 2017) (explicitly declining to follow the Ninth Circuit). Other Circuits, including the Fourth and Seventh, have followed the Ninth Circuit's approach. See Martineau v. Wier, 934 F.3d 385, 393–94 (4th Cir. 2019); Spaine v. Community Contacts, Inc., 756 F.3d 542, 547–48 (7th Cir. 2014).