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PROVEN TACTICS TO DEFEAT AND SETTLE CLAIMS ASSERTED BY BANKRUPTCY TRUSTEES AND DEBTORS

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When a bankruptcy petition is filed, all of the debtor's legal and equitable interests become part of the bankruptcy estate. The statutory definition of "property of the estate" is broad and includes all causes of action that belong to the debtor on the petition date, even if the debtor is unaware of such claims. For example, a debtor's pre-petition claims against third parties could include personal injury, breach of contract, and professional malpractice claims.

A growing body of law presents opportunities to defend or settle such claims using arguments and tactics that would not have been available if the debtor brought the claim outside of bankruptcy. When defending a claim brought by a bankruptcy trustee, a plaintiff who files a voluntary petition or is the subject of an involuntary petition while the lawsuit is pending, or a plaintiff who was a debtor in a recent bankruptcy case, your defense checklist should include these strategies.

TRUSTEE'S STANDING TO PROSECUTE AND SETTLE CLAIMS

A bankruptcy trustee inherits the debtor's pre-petition claims against third parties and is the only party with standing to bring such claims. A trustee is appointed automatically in chapter 7, 12 and 13 cases, and may be appointed in chapter 11 cases upon a showing of fraud or gross mismanagement. Thus, for a period of time after a bankruptcy filing, the debtor is divested of the right to decide whether to pursue, settle or dismiss a claim. The defendant or prospective defendant will deal instead with the bankruptcy trustee, who typically is an experienced, practicing bankruptcy attorney who doesn't share the debtor's emotional attachment to pursuit of particular claims.

If the trustee believes she can produce a net benefit for creditors of the debtor's estate by pursuing such claims, she may do so by hiring legal counsel. Trustees often request, and the bankruptcy court often approves, retention of the trustee's law firm to prosecute an action on behalf of the estate. The estate is unlikely to have ample resources to finance litigation, so the ability of trustee's counsel to get paid often depends on the outcome of the action. Limited resources may stack the deck in favor of avoiding protracted litigation. Frequently, the trustee's fiduciary duty to maximize the value of the estate for the benefit of creditors is satisfied through a prompt settlement.

Therefore, defense counsel and insurance companies with exposure on third party claims can obtain highly favorable outcomes by offering the trustee value in exchange for release and dismissal of the debtor's claims. If the trustee did not believe the claim was worth pursuing, then any recovery the trustee obtains through settlement will be seen as a win for the estate, whereas rejecting a reasonable offer could be seen as a breach of fiduciary duty. Even if the trustee believes the claim is valuable, the trustee may be willing to settle sooner and on more favorable terms than the debtor would have.

The trustee must file a motion seeking the bankruptcy court's approval of a settlement. The debtor and other creditors have an opportunity to review and ob-

ject to the settlement terms. However, approval of bankruptcy settlements is in the discretion of the court and is commonly granted unless the terms are well below the range of reasonableness. Once the settlement is approved, the debtor is precluded from asserting released claims at a later date.

CLAIMS AFTER BANKRUPTCY

It's a wise practice to check the plaintiff's name in the national PACER bankruptcy database before answering a complaint. A debtor who lists a claim against a third party on her bankruptcy schedules only regains standing to pursue the claim if the trustee abandons the action by failing to pursue or resolve it during the bankruptcy case. For the debtor who knowingly or unknowingly omits a pre-petition cause of action on her schedules, however, standing may be lost forever. Such an omission deprives the trustee of an opportunity to administer the asset. Therefore, the claim remains property of the estate and will not be deemed abandoned upon the close of the bankruptcy case. Parties defending such claims may argue with success that the debtor's post-bankruptcy prosecution of the action is judicially estopped as a result of the omission, or that the bankruptcy case should be reopened to allow the trustee to administer the claim.

TRUSTEE'S SALE OF CLAIMS AGAINST THIRD PARTIES

One increasingly seen option for trustees is the sale of third party claims on the open market. Underlying state or federal law may prohibit the sale or assignment of certain claims, but the Bankruptcy Code contains no independent restriction. At such sales, nothing prevents the debtor from buying the claim from the estate or the defendant from being the successful bidder at the auction. A defendant's acquisition of adverse claims can be an effective and comparatively inexpensive way to eliminate risk.

Recent case law illustrates the preclusive effect that a bankruptcy sale has on the debtor-plaintiff's rights following bankruptcy. In *Duncan v. Stokes* (*In re: Stokes*), 2013 WL 492477 (Bankr. D. Mont. February 8, 2013), the debtor retained an attorney to file a chapter 11 bankruptcy petition. After the petition was filed, the attorney withdrew from representation. The debtor's case was converted to chapter 7, and two years later the debtor filed a malpractice action in state court against his former bankruptcy attorney. The chapter 7 trustee intervened and obtained a stay of the state court action pending a determination by the bankruptcy court of whether the malpractice claim was property of the bankruptcy estate. Because the malpractice claim accrued pre-petition, the bankruptcy court found that the claim was property of the estate and could be auctioned by the trustee.

The debtor's former bankruptcy attorney was the high bidder and purchased the claim against him. Thereafter, the attorney filed an adversary proceeding in bankruptcy court seeking a declaratory judgment that the debtor was estopped from prosecuting the state law claim. The bankruptcy court ruled that the claim had been fully administered through the auction. This precluded any further prosecution of the claim in state court.

DEFENDANT'S PAYMENT OR PURCHASE OF CLAIMS AGAINST THE DEBTOR

Contrary to popular belief, the Bankruptcy Code does not require a debtor to be insolvent to file a bankruptcy petition. However, if there are no creditors who would benefit from the trustee's efforts, then the trustee's claims may fail. When defending against bankruptcy-specific causes of action, such as a trustee's attempt to avoid a preferential pre-petition transfer or a fraudulent transfer, the Code states that any recovery is "for the benefit of the estate." Bankruptcy courts have held that if there are no creditors, then there is no estate to benefit from the trustee's claims and they should be dismissed.

Therefore, defendants in avoidance actions should closely review the debtor's bankruptcy schedules, docket and claims register. Occasionally, defendants find that the aggregate amount of claims against the debtor is far less than the defendant's litigation exposure or anticipated costs of defense. In such cases, the best strategy to defeat the trustee's avoidance action may be to pay the debtor's creditors directly and move to dismiss the case. Alternatively, the creditors' claims might be purchased for full value or at a discount and waived as to the debtor's estate, but reserved as to potential collection efforts against other non-bankrupt co-borrowers and guarantors.

THE "IN PARI DELICTO" DEFENSE

Lastly, in defending against claims brought by a bankruptcy trustee, sometimes the most obvious defense is the one that gets overlooked. A trustee succeeds to the debtor's prepetition rights, and for some purposes in a bankruptcy case is treated as a hypothetical creditor and bona fide purchaser without knowledge of facts that could impede recovery for the benefit of the estate. Nevertheless, in at least some jurisdictions bankruptcy trustees are subject to the affirmative defense of *in pari delicto* ("in equal fault"), which precludes a plaintiff who participated in the same wrongdoing as the defendant from recovering damages resulting from that wrongdoing.

The *in pari delicto* defense was used successfully in a recent Fourth Circuit Court of Appeals case to bar claims brought by the assignee of a bankruptcy trustee against defendants who allegedly participated in a Ponzi scheme. *In re Derivium Capital LLC*, 716 F.3d 355, 367 (4th Cir. 2013). Recognizing that appellate courts in the Seventh and Ninth Circuits declined to apply the defense in bankruptcy cases that involved claims asserted by receivers, the Fourth Circuit distinguished bankruptcy trustees from receivers because the Bankruptcy Code grants trustees rights that are no greater than the rights the debtor had.

CONCLUSION

Given the array of options available to dispose of claims brought by a bankruptcy trustee, a plaintiff's/debtor's bankruptcy filing may be a welcome development, especially if the trustee recognizes the allegations are weak, too expensive to pursue, or motivated by personal grudges or greed. Proactive defendants can seize the chance to find an effective and comparatively inexpensive resolution in bankruptcy court.

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