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A bankruptcy primer for employment practitioners

WHAT TO DO IF A DEFENDANT – OR YOUR OWN CLIENT – FILES BANKRUPTCY

Given the current economic climate, it is likely that an employment practitioner asserting employment claims on behalf of an aggrieved employee may encounter an employer who files bankruptcy. Counsel may also learn that their own client has filed bankruptcy. A bankruptcy filing by either party significantly impacts an employment lawsuit. Therefore, knowledge of bankruptcy basics is likely to prove useful to employment litigators.

This article identifies typical issues that arise when an employer in an employment lawsuit files bankruptcy, or when the plaintiff-employee files bankruptcy, and offers tips and suggestions to plaintiff's counsel. While this article does not identify or address every issue that may arise when a party to an employment lawsuit files bankruptcy, it should enable plaintiff's counsel to address routine bankruptcy issues and to identify issues that require consultation with a bankruptcy specialist.

Bankruptcy basics

Congress has codified bankruptcy law in Title 11 of the U.S. Code ("Bankruptcy Code"). The most common chapters under the Bankruptcy Code are Chapter 7 (Liquidation) and Chapter 11 (Reorganization), although individuals can also file cases under Chapter 13 (Adjustments of Debts of an Individual With Regular Income). In a Chapter 7 case, a trustee is appointed by the bankruptcy court to liquidate the debtor's assets and distribute the proceeds to creditors. Under Chapter 11, the debtor typically remains in control of its operations, and implements a plan of reorganization to emerge from bankruptcy still in business. Under Chapter 13, a trustee is appointed by the bankruptcy court to oversee the individual debtor's repayment plan.

Procedure in Bankruptcy Court is governed by Federal Rules of Bankruptcy Procedure ("FRBP"), akin to the Federal Rules of Civil Procedure. Additionally, each bankruptcy court has established its own local rules. Bankruptcy court decisions are reported in the Federal Bankruptcy Reporter, and are appealable first to specially created "Bankruptcy Appellate Panels" in some circuits, including the Ninth Circuit, or to U.S. district courts. Subsequent appeals are to the federal circuit courts, and then to the U.S. Supreme Court.

Interplay between bankruptcy law and substantive law

Bankruptcy law generally does not confer or address substantive rights and issues. The Bankruptcy Code is a procedural overlay that enables a debtor – the party filing bankruptcy – to reorganize its business, or alternatively, liquidate its assets, and distribute proceeds pro rata to creditors: those to whom the debtor owes financial obligations.

Substantive California non-bankruptcy law continues to apply to a creditor's claims against the debtor. Thus, if, for example, an employee asserts a claim under the California Federal Employment and Housing Act (FEHA) against a bankrupt employer, the FEHA will govern the merits of the employee's claim even if the bankruptcy is filed in another state, which is common.

Bankruptcy venue provisions allow an entity to file bankruptcy in its state of formation as well as the state in which it is headquartered. Corporations incorporated in Delaware, New York, or Texas, but headquartered in states other than Delaware, New York, or Texas routinely file bankruptcy in Delaware, New York, or Texas based on the perception that Delaware, New York, and Texas bankruptcy courts are the most debtor-friendly courts in the country. If employment counsel is going to appear in a bankruptcy case outside of California, counsel should seek admission *pro hac vice* and consider retaining local bankruptcy counsel.

Information-gathering through the bankruptcy forum

One benefit of bankruptcy is that it affords creditors information concerning debtors not available in general litigation. A debtor is required to file schedules and a statement of financial affairs detailing the debtor's assets and liabilities, contracts and leases with third parties, the identities of the debtor's owners, the debtor's income, and payments made by the debtor within two years preceding the bankruptcy.

Because a debtor is required to disclose all of its assets and liabilities, an employee can discover an employer's net worth at the outset of a case without serving discovery. Absent the bankruptcy, the employee would not be able to obtain such information without serving discovery requests, and would not be entitled to conduct such discovery without first obtaining a court order after establishing a substantial probability of prevailing on a claim for punitive damages. (Civ. Code, § 3295, subd. (c).)

Through the "Pacer" electronic filing system, found at www.pacer.psc.uscourts.gov, counsel can access these and other

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pleadings online. Pacer requires registration through a login and password. There is a nominal cost to retrieve documents electronically.

In larger bankruptcy cases, the debtor employer will retain a "claims agent." A claims agent maintains a mirror image of the court's docket, as well as other useful information regarding the bankruptcy case, on the claims agent's website. Anyone can access such information free of charge.

Counsel can also file a "Request for Special Notice," requesting that other parties in the case serve the filing party with all pleadings filed in the case. Bankruptcy courts have their own local rules regarding the procedures for filing requests for special notice.

Bankruptcy also affords broad discovery rights. At the outset of a bankruptcy, the United States Trustee or Chapter 7 Trustee will conduct an examination of the debtor. The examination, or initial meeting of creditors, is codified in Bankruptcy Code sections 341(a) and 343. Creditors may appear and question the debtor. Under Federal Rule of Bankruptcy Procedure ("FRBP") 2004, with court approval, a non-debtor party to an employment lawsuit may depose any entity, including the debtor, concerning the debtor's acts, conduct, property, liabilities, and financial condition, or any matter which may affect the administration of the debtor's estate, or the debtor's right to a discharge.

The scope of a deposition under FRBP 2004 is extremely broad, typically broader than the scope of a deposition in the underlying employment case. Different courts have different rules regarding examinations under FRBP 2004 concerning, among other things, how to obtain a court order authorizing the examination, whether examinations are appropriate given the pendency of a state or federal court lawsuit, and serving subpoenas on non-debtor examinees. Counsel should be certain to consult local rules or a bankruptcy specialist when seeking to conduct an examination under FRBP 2004.

When the employer files bankruptcy

Automatic stay

Upon the employer's bankruptcy filing, the "automatic stay" takes effect and precludes the employee from proceeding with the employment lawsuit in state or federal court. (Bankruptcy Code, § 362.) The theory of the automatic stay is that when a debtor files bankruptcy, the debtor should be able to focus on reorganization efforts without the distraction of litigation. The stay also prevents any particular creditor from obtaining a comparative advantage against the debtor vis-à-vis the debtor's other creditors. Any action in the lawsuit taken after the bankruptcy filing is void. Moreover, the employee is liable to the employer for damages, possibly including attorneys' fees and punitive damages, if the employee takes action in violation of the automatic stay, knowing of the bankruptcy filing. (Bankruptcy Code, § 362, subd. (k)(1).) Therefore, once a plaintiff learns about an employer's bankruptcy filing, the plaintiff should not proceed with the lawsuit.

The bankruptcy court will adjudicate the employee's claims through the claims adjudication process, discussed below. Alternatively, the employee may seek "relief from stay" to proceed in the non-bankruptcy forum. Even if the plaintiff obtains relief from stay, the plaintiff will not receive payment on any judgment or settlement. Rather, the plaintiff will have an "allowed claim" entitling him or her to a pro rata distribution based on distributions to unsecured creditors at such time that distributions are made. An exception to this rule is if there is Employment Practices Liability Insurance ("EPLI") or other applicable insurance coverage, in which case the plaintiff will be entitled to payment from the proceeds of such coverage, subject to any other claimants that are also entitled to payments from such coverage.

An employee is entitled to relief from stay "for cause." (Bankruptcy Code, § 362, subd. (d)(1).) In determining whether "cause" exists, many courts follow some variation of a multi-factor test comparing the benefits and burdens of deciding the claim in bankruptcy court versus a non-bankruptcy forum. (*In re Sonnax Indus*. (2d Cir. 1990) 907 F.2d 1280, 1286.) The test considers, among other things, whether all substantive issues would be resolved in the state or federal court, whether granting relief would interfere with the bankruptcy case, whether specialized legal knowledge by the judge is required, whether EPLI coverage exists, whether there are non-debtor third parties involved in the lawsuit, whether other creditors will be prejudiced if relief is granted, and whether the parties are ready for trial in the state or federal court. (*Ibid.*)

Different factors apply based on the circumstances. Bankruptcy judges have broad discretion in granting or denying relief from stay. (*In re Mazzeo* (2d Cir. 1999) 167 F.3d 139, 143.) Employment counsel should consult the local rules of the particular bankruptcy court or a bankruptcy specialist to determine the procedural requirements of a relief from stay motion. For example, in the Central District of California, parties moving for relief from stay must use court forms, which are available on the Central District of California Bankruptcy Court's website.

Proof of claim

A proof of claim is the pleading by which an employee describes the claim. Most bankruptcy courts use a one-page form available on their websites. The form is simple to complete, requiring the employee to describe, among other things, contact information for the employee's counsel, the basis for the claim, the classification of the claim (i.e., unsecured), when the claim arose, and the amount of the claim. In addition to completing the form, which should be signed by the employee, counsel should attach the state or federal court complaint and any documentary evidence supporting the claim.

Under applicable bankruptcy law, filing a proof of claim waives the employee's right to a jury trial in bankruptcy court. (*Langenkamp v. Culp* (1990) 498 U.S. 42, 45 [111 S.Ct. 330,

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112 L.Ed.2d 343]; *Granfinanciera, S.A. v. Nordberg* (1989) 492 U.S. 33, 59, footnote 14 [109 S.Ct. 2782, 106 L.Ed.2d. 26].) Yet if the employee does not file a proof of claim, the employee will receive no distribution from the bankruptcy estate because filing a proof of claim is a prerequisite to receiving a distribution. Given the option of a bench trial versus not having a claim, the employee is probably better off filing a proof of claim. Moreover, even if the employee files a proof of claim, if the employee obtains relief from stay, the employee may nevertheless be able to have a jury trial anyway.

In Chapter 7 cases, the employee generally must file the proof of claim no later than 70 days after the first date set for the meeting of creditors under Bankruptcy Code section 341, subdivision (a). (Fed. Rules Bankruptcy Proc. § 3002, subd. (c).) A continuance of the first meeting of creditors does not postpone the deadline for filing a proof of claim. In Chapter 11 cases, the court sets the deadline. (Fed. Rules Bankruptcy Proc. § 3003, subd. (c)(3).)

If no one objects to an employee's proof of claim, the employee has an "allowed," or valid, claim. Unless there are insurance proceeds to pay the claim, the employee will receive only a pro rata distribution of funds distributed to unsecured creditors.

If someone objects to the employee's claim and the employee does not obtain relief from stay, the bankruptcy court will resolve the claim. The FRBP and local rules establish a litigation process similar to general litigation procedures in state or federal court, including pleadings to put a case at issue, a "meet and confer" process, discovery, pre-trial motions, and trial. Typically, the litigation process is faster and less comprehensive in bankruptcy than in general civil litigation.

Discharge

Employers are entitled to a discharge of their debts, including employment claims, under a Chapter 11 plan of reorganization or liquidation. (Bankruptcy Code, § 1141, subd. (d)(1)(A).) Any portion of the employee's claim not paid under the plan will be extinguished as against the debtor. (*Ibid*.) The employee, however, still may have recourse against third parties or insurance. First, to the extent that the employee has claims against non-debtor third parties, such as co-employers or individual wrongdoers, such claims will not be discharged and the employee will be able to pursue them.

Second, if there are EPLI insurance proceeds available to cover the claim or other applicable insurance coverage, the discharge of the employer's debts will not preclude the employee from pursuing insurance proceeds, and in fact, the employee can proceed nominally against the employer, to collect against the insurer. (*In re Coho Res., Inc*. (5th Cir. 2003) 345 F.3d 338, 342-343.)

When the plaintiff employee files bankruptcy

An employment claim that exists as of the date the employee files bankruptcy is property of the bankruptcy estate. (Bankruptcy Code, § 541, subd. (a)(1).) Any recovery on such claim belongs to the estate, and not to the employee individually. (*Ibid.* [except for inapplicable exceptions, property of the estate includes all legal or equitable interests of the debtor in property].) A claim that arises only after the bankruptcy filing is not property of the estate, but belongs to the employee individually. (*Ibid.* [except for inapplicable exceptions, property of the estate includes all legal or equitable interests of the debtor in property *as of the commencement of the case*].) In the case of employment litigation, issues could arise as to whether a particular claim arose before or after the bankruptcy petition was filed. For example, if the employee was hired before filing bankruptcy and terminated after filing bankruptcy, whether the claim is pre-bankruptcy or post-bankruptcy may depend upon the substantive employment claim asserted. The significance of this distinction is that the employee, who is probably the key witness in the case, may lose the incentive to pursue the claim if any recovery will inure only to the benefit of the employee's creditors.

Tips for plaintiff's counsel when the employer files bankruptcy

Make sure proceeding is cost effective

Unless there is Employment Practices Liability Insurance ("EPLI") or other applicable insurance coverage, or solvent non-debtor co-defendants, an employee's recovery on any allowed claim will be limited to distributions from the bankruptcy estate. Employees are usually unsecured creditors. Distributions to unsecured creditors are often pennies on the dollar. Therefore, when the employer files bankruptcy, the employee should conduct a cost-benefit analysis to determine whether the likely recovery will outweigh the costs of litigation.

Use FRBP 2004

Since FRBP 2004 provides an examining party wide latitude in deposing a bankrupt employer, plaintiff's counsel should use FRBP 2004. For example, if an employee is suing two defendants, and only one is in bankruptcy, in addition to conducting discovery in the state court lawsuit against the non-bankrupt defendant, counsel can conduct broader discovery in the debtor's bankruptcy regarding the assets or liabilities of the debtor.

Seek relief from stay

Counsel should consider seeking relief from stay to maximize the likelihood of a jury trial. Moreover, where the employer files bankruptcy in another state, the plaintiff is better off with relief from stay because the plaintiff will be able to litigate the case in a California court rather than a remote bankruptcy court.

Claim procedures in wage-hour class actions

Federal Rule of Bankruptcy Procedure 7023, similar to Federal Rule of Civil Procedure 23, authorizes class claims in bankruptcy cases. Class claims are beneficial to wage and hour class actions. Counsel and the named representatives should execute an FRBP 2019 Verified Statement of Representation. (*Reid v. White Motor Corp*. (6th Cir. 1989) 886 F.2d 1462, 1470-1471, *cert. denied*, 494 U.S. 1080 [110 S. Ct. 1809, 108 L. Ed. 2d 939].) FRBP 2019

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provides that if counsel or a creditor is representing more than one party, counsel and the creditor must file a verified statement disclosing the particulars of the representation. While many courts allow class claims, one court has reached a contrary conclusion. The following courts have allowed class claims to be filed: (*In re American Reserve Corp*. (7th Cir. 1988) 840 F.2d 487; *Reid v. White Motor Corp*., *supra*; *In re Charter Co*. (11th Cir. 1989) 876 F.2d 866, 868-873; *In re Woodward & Lothrop Holdings, Inc*. (Bankr. S.D.N.Y. 1997) 205 B.R. 365, 369; *In re Chateaugay Corp*. (S.D.N.Y. 1989) 104 B.R. 626, 634.) The Tenth Circuit reached the contrary conclusion in *In re Standard Metals Corp*. (10th Cir. 1987) 817 F.2d 625, 630. When counsel files a class claim, counsel should request the court to apply FRBP 7023 and seek class certification promptly after filing the class claim, even where class certification was obtained pre-bankruptcy. Class claim issues are complicated and vary from circuit to circuit. Class counsel should consider consulting a bankruptcy specialist.

Obtain leverage in asset sales by alleging successor liability

Chapter 11 debtors often seek to sell their assets in bankruptcy. Buyers typically insist on acquiring the assets free and clear of all liens and claims, including litigation claims against the seller/corporate debtor. An employee with claims against the seller may legitimately obtain leverage by objecting to a sale to the extent the seller seeks to sell assets free and clear of the employee's successor liability claim against the buyer with respect to the employment claims.

Most case law suggests that a bankruptcy court can authorize a sale of assets free and clear of employment claims. (See, e.g., *In re TWA, Inc.* (3rd Cir. 2003) 322 F. 3d 283; *In re Leckie Smokeless Coal Co*. (4th Cir. 1996) 99 F.3d 573, 576; *Myers v. U.S.* (Bankr. S.D. Cal. 2003) 297 B.R. 774, 780-86.) However, at least one court has concluded that a bankruptcy proceeding is not an absolute bar to finding successor liability against the purchaser. (*Chicago Truck Drivers, Helpers & Warehouse Workers Union (Indep.) Pension Fund v. Tasemkin, Inc*. (7th Cir. 1995) 59 F.3d 48, 49 [if the purchaser had notice of the claim and there is "substantial continuity" between the seller and the purchaser, there may be successor liability].) Rather than asking the court to establish successor liability, plaintiff is more likely to obtain relief by requesting that the court not rule on successor liability in approving the sale. By using this leverage, plaintiff may be able to negotiate a resolution of the employment claim against the seller because the purchaser is not likely to proceed with the sale with any uncertainty as to successor liability.

Wage-claim priority

Employees owed wages or other benefits such as vacation pay earned during the six months preceding the bankruptcy are entitled to priority for such amounts, currently up to $13,650 per employee. (Bankruptcy Code, § 507, subd. (a)(4).) Priority claims get paid ahead of general unsecured claims. This could be significant in wage and hour cases.

Where the employer is on the brink of bankruptcy, take issues into account

During the lawsuit, plaintiff may learn that the employer is on the brink of bankruptcy. A bankruptcy filing by the employer even after the employee has either settled with or prevailed against the employer can have significant impacts on the plaintiff, including (1) having to return to the bankruptcy estate as a "preference" any payments received by the employee on a judgment or settlement within the ninety days preceding the bankruptcy filing (Bankruptcy Code, § 547), or (2) to the extent that the employee has not been paid on the settlement or judgment or is required to return such payment to the bankruptcy estate, having the claim discharged. (See Section 3 above under "When the Employer Files Bankruptcy.")

The employee can mitigate these impacts by including certain provisions in settlement agreements and forms of judgment. For example, the settlement agreement should include a qualification to the timing and effectiveness of the employee's release of the employer setting forth that the employee's release against the employer does not become effective until the 91st day after the employee receives the settlement funds, or the final installment thereof if the settlement is made in multiple payments, and only if the employer has not filed a voluntary bankruptcy petition or become the debtor in an involuntary bankruptcy case during that 91-day period.

In addition to the foregoing provision, a settlement agreement could provide that if the employee is required to return the settlement payment as a preference, the employee has an allowed claim in the employer's bankruptcy equal to the full amount of the employee's alleged damages (which amount should be specified in the settlement agreement), rather than the lesser compromised amount. Counsel should consider consulting with a bankruptcy specialist to help mitigate the impacts of the employer's insolvency risk.

Tips for plaintiff's counsel when the employee files bankruptcy

Any attorney working on behalf of the bankruptcy estate must be employed and approved by the court prior to commencing legal services. (Bankruptcy Code, § 327, subd. (a).) This includes contingent or hourly fee counsel. Pursuant to Bankruptcy Code section 327, subdivision (e), counsel who represented the employee pre-bankruptcy may continue to represent the employee or the estate post-bankruptcy with respect to the employment claims so long as counsel does not have a claim against the employee. If counsel is being paid on a contingency fee basis, it is unlikely that counsel will have a pre-bankruptcy claim against the employee for unpaid fees. If counsel's retention is not approved by the court, counsel will not be entitled to payment for services rendered after the bankruptcy filing. Obtaining court approval is a fairly routine matter involving a motion and order. Typically, the employee will have retained separate bankruptcy counsel, who can prepare the

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employment application or assist employment counsel in doing so. Alternatively, assuming that the employee has filed Chapter 7, the Chapter 7 trustee, who will be retaining employment counsel on behalf of the estate, can prepare the employment application or assist employment counsel with the employment application.

Assuming the employee's claims arose pre-bankruptcy, as noted above, once the employee files bankruptcy, the claims belong to the estate, not to the employee. Thus, counsel's client technically becomes the trustee on behalf of the estate. That is why the trustee will have to retain counsel. Obtaining a court order authorizing employment does not automatically authorize payment. Therefore, counsel will either need to include in the employment application a request for authorization to make a contingency fee payment when proceeds become available, or at such time that the employment claim is resolved, counsel will have to bring a separate "fee" application to be paid.

Based on the foregoing, as part of counsel's routine intake process, for two reasons, counsel should inquire of potential employee clients whether they previously have been, or currently are, debtors in bankruptcy. First, as noted above, if the potential employee client is currently in bankruptcy, counsel will need to coordinate with the employee's bankruptcy counsel or the bankruptcy trustee to be employed and paid.

Second, as set forth above, under Bankruptcy Code Section 541, subdivision (a)(1), causes of action are property of the estate. Debtors are required to file schedules of their assets and liabilities. (Bankruptcy Code, § 521, subd. (a)(1)(B)(i).) A debtor with knowledge of employment claims that arose before the debtor filed bankruptcy who fails to schedule such claims may be barred through judicial estoppel from pursuing them, as failing to schedule a claim when required to do so may be an admission that no such claim exists. (*In re Superior Crewboats, Inc.* (5th Cir. 2004) 374 F.3d 330, 335, see also, *Slater v. U.S. Steel Corp.* (11th Cir. 2017) 871 F.3d 1174 [whether a plaintiff is judicially estopped from pursuing claims based on the plaintiff's failure to schedule claims depends on factual circumstances that determine whether the plaintiff intended to "make a mockery of the judicial system," not solely on the plaintiff's failure to schedule the claims].)

Moreover, for the reasons stated above with respect to (1) employment and fee applications, (2) the bankruptcy trustee as the decision-maker for claims arising before bankruptcy, and (3) the requirement that the employee include pre-bankruptcy employment claims on its schedules, even if a potential employee client has never been a debtor in bankruptcy, counsel should consider including in their engagement letters an agreement by the client to inform counsel if the client files or intends to file bankruptcy. If that happens, counsel should coordinate with the client's bankruptcy counsel.

Finally, counsel should be aware of substantive bankruptcy law that provides a cause of action to an individual for discrimination in employment based on the individual having filed bankruptcy. Under Bankruptcy Code section 525, an employer may not terminate the employment of, or discriminate with respect to employment against, an individual who is or has been a debtor in bankruptcy solely because the individual has been a debtor in bankruptcy. (See, e.g., *In re Hicks* (Bankr. W.D. Ark. 1986) 65 B.R. 980 [employee entitled to reinstatement as bank teller where she was removed as bank teller and transferred to non-public contact position for being a bankruptcy debtor].)

Conclusion

A bankruptcy filing by a party to an employment discrimination lawsuit injects uncertainty for plaintiff employee's counsel. With knowledge of applicable basic bankruptcy concepts and issues, counsel can handle more routine matters on their own, and determine when to consult a bankruptcy specialist.

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