

When Bankruptcy Precludes Employment Claims

Law360, New York (December 03, 2012, 11:32 AM ET) -- A common interrogatory or deposition question often posed to a plaintiff in an employment lawsuit is: "Have you filed for bankruptcy, and if so, when?" This question is not academic. The answer, in fact, could have significant implications for the prosecution of an employment lawsuit, including dismissal of the lawsuit or requiring substitution of parties.

The case law is consistent — a bankruptcy filing fundamentally alters the judicial standing of the employee plaintiff to proceed with an employment discrimination lawsuit. A recent decision from the Sixth Circuit Court of Appeals in *Auday v. Wet Seal Retail Inc.*, 12-cv-5057 (6th Cir. Oct. 25, 2012), reaffirms how a bankruptcy filing could preclude the plaintiff from pursuing her claims.

Background

Four days after the plaintiff, Karen Auday, was fired from her job with clothing retailer Wet Seal in September 2009, she and her husband filed for Chapter 7 bankruptcy. Some three months after Auday filed her bankruptcy petition, her employment lawyer wrote to the bankruptcy trustee to inform him that Auday believed she was discriminated against on the basis of her age. However, this information was not shared with the bankruptcy court and the bankruptcy court discharged Auday from her debts in January 2010.

In February 2010, after Auday's debts had been discharged, the trustee applied to the bankruptcy court for authority to hire Auday's employment lawyer to pursue the claim against Wet Seal. Notice of the application and opportunity to object were sent to Auday's creditors. The bankruptcy claim, however, was never amended. The bankruptcy court granted the trustee's application, appointing Auday's employment attorney as a special counsel to the trustee.

Five months later, for some unexplained reason, Auday, as opposed to the bankruptcy trustee, sued Wet Seal in state court, and the case was subsequently removed based on diversity jurisdiction. The district court granted judgment on the pleadings to Wet Seal, holding that Auday's failure to list the potential employment claim on her bankruptcy petition judicially estopped her from later bringing the claim.

On appeal, the court also ruled, on a different basis, that Auday could not bring a claim. As the court explained, when Auday filed for bankruptcy, her estate became the owner of all of her property, including tort claims that accrued before she filed her bankruptcy petition. Because Auday's employment claims accrued when she was fired, those claims became property of her estate when she filed for bankruptcy four days later.

As such, absent abandonment of the claim in bankruptcy, only the bankruptcy trustee, as the real party in interest, may bring the discrimination claim. The plaintiff lacked standing to pursue the claim alone. On this basis, the appellate court vacated the judgment and remanded the case to the district court either to allow Auday to dismiss the action or to allow Auday to amend her complaint to substitute the bankruptcy trustee as the plaintiff.

Implications

This case reinforces the impact of a bankruptcy filing on subsequent employment litigation. If a client has filed a Chapter 7 bankruptcy, plaintiffs' employment attorneys must determine if the bankruptcy trustee will abandon the claim. The trustee may choose to do that if the trustee assesses the case as having less merit, for example. Abandonment would require the bankruptcy trustee to give notice to creditors and if any object, the bankruptcy court must hold a hearing. The claim could also revert to the plaintiff if the plaintiff lists the complaint on his or her schedule of assets and if the bankruptcy court closes the case without disposing of it.

A bankruptcy filing does not necessarily permit an employer defendant to escape liability for its allegedly discriminatory acts. Under Fed. R. Civ. P. 17(a)(3), the district court may join or substitute the real party in

interest, such as a bankruptcy trustee. The district court also has the option of permitting a substitution to relate back to the date of the original complaint. Assuming the court allows substitution of the trustee, the trustee could pursue the litigation, and if successful, could recover proceeds that would go to the plaintiff/debtor's creditors.

Thus, while this procedural defense would seem to be merely a tactic to stall resolution of the merits of the claim, from a defense perspective, because the plaintiff/debtor would have less incentive to proceed with pursuing the employment claim, the settlement value of the case could be significantly impacted.

Thus, both plaintiffs and defense counsel should know whether the plaintiff has filed a Chapter 7 bankruptcy and appreciate the implications for the bankruptcy filing on subsequent employment litigation.

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