When Bankruptcy Intervenes

The Pros and Cons of Bankruptcy Court Jurisdiction

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Bankruptcy, like death and taxes, is a concept few wish to consider until there is no other option. But in some litigation, the consideration of bankruptcy is forced on the parties when one of the litigants—most often a defendant who expects to lose at trial—files a petition in bankruptcy court on the eve of trial and removes the litigation to bankruptcy court.

The most common response by the plaintiff or other non-debtor litigants is to file immediate motions for remand and relief from the automatic stay in an effort to avoid the dreaded jurisdiction of the bankruptcy court and return to the safety of the state court's jurisdiction. But as with taxes—perhaps less so with death—a few moments of reflection and careful planning can ensure a new perspective. And in many cases, that perspective might lead the non-debtor litigants to conclude that the bankruptcy court is the preferred forum for the resolution of their litigation.

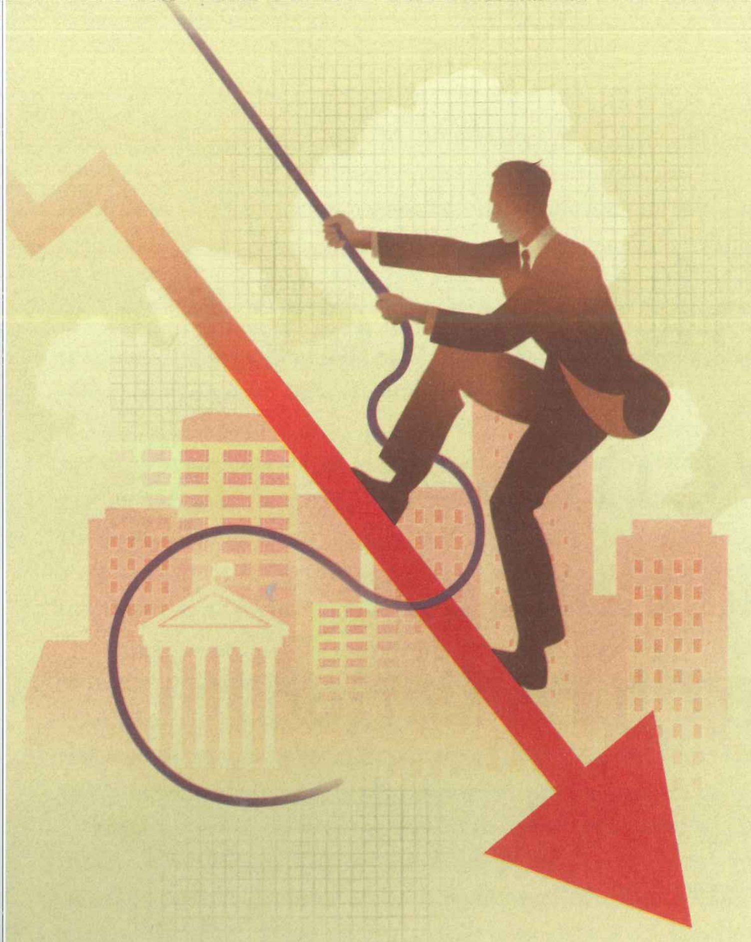
Bankruptcy court is a foreign jurisdiction for most litigators, saddled by unique procedural rules, a complicated federal code, and many myths about its practices. Many litigators presume that the bankruptcy court presents a debtor-friendly forum that will not provide their clients with a fair trial, that the judge will not be familiar with applicable state law, and that the costs of trial will be higher.

But while every case is unique, acceptance of the bankruptcy court's jurisdiction could provide your client with a far quicker trial date, a far quicker resolution of dispositive motions, a judge more familiar with commercial law, and even an opportunity to foreclose the debtor's right to a jury trial more easily than could be accomplished in state court. In some cases, where the debtor does not remove litigation to bankruptcy court, it might even be in the interests of non-debtors to remove the action themselves to avoid the lengthy delays that can arise when litigation stagnates in state court during a bankruptcy proceeding.

This article examines some of the benefits that can be obtained from allowing litigation to proceed in bankruptcy court and some of the myths about that forum that might not survive scrutiny. Death and taxes may be certain, but the common perception that bankruptcy court jurisdiction is harmful to your case might fall by the wayside.

To begin with, one of the most common perceptions about bankruptcy court jurisdiction is that the debtor enjoys a "home court advantage" when litigation is removed. Certainly, there are some bankruptcy judges who have a reputation for being "debtor friendly," but there are also many who are generally known for being "creditor friendly." And labels such as these are often entirely irrelevant when the nature of the debtor/defendant is considered.

For example, if the debtor/defendant is a nonprofit that helps homeless veterans and has an untarnished record of financial propriety, it likely matters little which bankruptcy judge will



preside over the case, and you may wish to consider seeking remand to state court. But if the debtor/defendant is a company that has been accused of fraudulent activity in multiple lawsuits, even the most "debtor friendly" judge might be preferable to a state court judge.

For while a state court judge is unlikely to learn much, if anything, about the defendant before trial is under way, a bankruptcy judge will learn a great deal about the debtor/defendant long before any lawsuits go to trial. There will be status conferences, other litigation that is removed or filed, motions for relief from the automatic stay, discovery disputes, and perhaps an effort to have a trustee appointed in cases of extreme fraud or to have the case converted to a liquidation. By the time a trial begins, a bankruptcy judge will already have formed a solid opinion about the nature of the debtor/defendant, and that could be an opinion that works in your favor. A bankruptcy judge who learns of the debtor's history and practices may be far more useful than a state court judge left in the dark until witnesses appear on the stand at trial.

Bankruptcy Timing

Timing also warrants consideration. Bankruptcy is often filed by a defendant on the eve of trial as a delaying tactic and to obtain whatever leverage might be gained from both the delay and change of forum. But a debtor's removal of litigation on the eve of trial is considered a sign of bad faith, and bankruptcy courts will typically favor remand under such circumstances. Where the removal was noticed a few days before trial, it might be possible to get an emergency hearing on a remand motion in order to preserve the trial date in state court.

More typically, a debtor will remove the case on the literal eve of trial, or even the morning of, ensuring the trial date is lost. Less typically, a debtor might remove litigation that is months away from trial, or before a trial date is even set. In each case, there is less reason to immediately seek a return to state court. For example, if the litigation is pending in California, where significant budget cuts have burdened courts' calendars, the loss of a trial date could mean a delay of a year or more before a trial could be scheduled again in state court. Efforts to obtain remand could take a month or two or even longer, given the general concept in bankruptcy that a debtor should be granted a "breathing spell." After that, the next status conference in state court might be a few months away, and by the time the new trial date is set, it could easily be a year after removal. An alternative to this process would be to accept bankruptcy court jurisdiction and seek an early trial date there.

The availability of a prompt trial in bankruptcy court depends on many factors that would exist in any forum—finality of the pleadings, the status of discovery, pending dispositive motions, the expected length of trial—but as a general matter bankruptcy courts may be able to schedule a trial much sooner than state court, and the time spent fighting over a remand motion (and possible appeal) could instead be spent preparing for trial.

Bankruptcy court jurisdiction might also provide far speedier resolution of dispositive motions. At a recent case management conference in California Superior Court, the judge offered my client a trial date over a year away and a hearing on summary judgment 12 months away—if I committed immediately to filing a summary judgment motion. By contrast, bankruptcy courts typically have open calendars and a self-calendaring procedure, allowing a summary judgment motion to be heard five or six weeks from filing, and other motions to be heard on 21 days' notice.

Of course, every case presents different facts. A trial that is expected to take three weeks or more might be held over three or four weeks in state court, yet spread over several months in some bankruptcy courts. Some state courts have managed budget cuts without substantial trial delays, while some bankruptcy judges might be facing uncharacteristically crowded calendars. The key is to pause, consider the facts, and make an informed decision about the forum that presents the optimal circumstances for pursuit of your client's case. For reasons of timing, the bankruptcy court might offer a much quicker resolution.

Illustrations by Stuart Briers

Right to a Jury

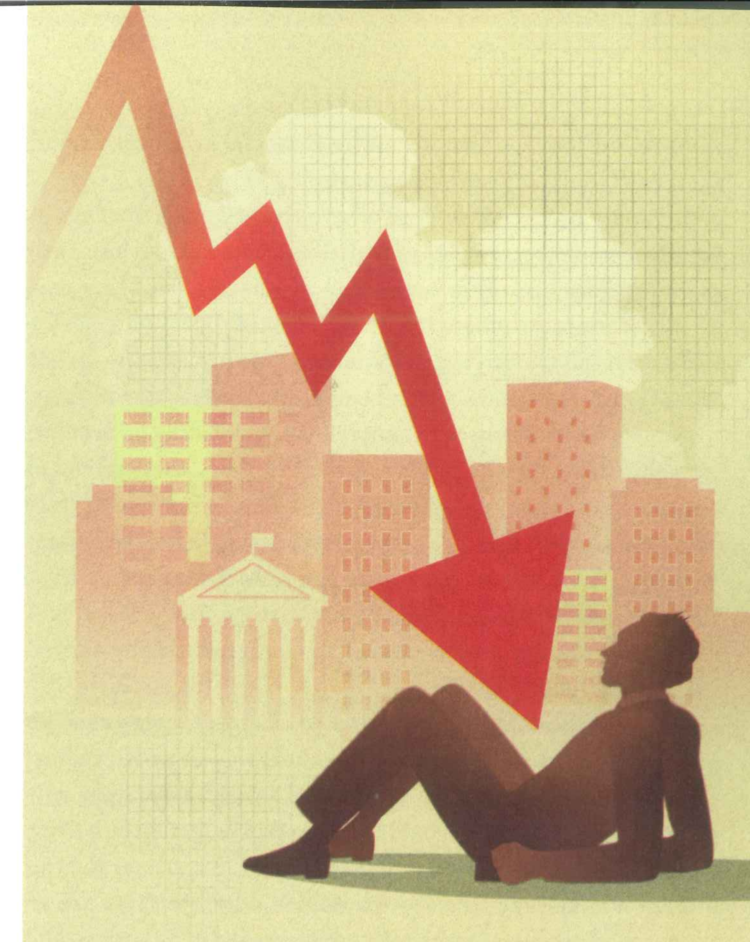
What about the right to a jury? In most cases, it is easier to secure the right to a jury trial against a defendant in state court than against a debtor in bankruptcy court. Conversely, though, it may be easier to enforce a waiver of the right to a jury trial if the action remains in bankruptcy court.

While waiver of the right to a jury trial differs under the laws of each state, California provides a useful example. Thanks to recent amendments to section 631 of California's Code of Civil Procedure requiring prompt payment of jury fees, California plaintiffs can easily waive their right to a jury trial through an administrative error. In bankruptcy court, as in all federal courts, the right to a jury trial must be timely asserted in the pleadings. The important difference, however, is that the standard that applies to a request to be relieved of an unintentional jury waiver differs substantially between many federal and state courts. By statute, California courts use their discretion when considering a request for relief from a waiver, and case law explains that any doubt should be resolved in favor of restoring the right to trial by jury. But in the Ninth Circuit, federal courts strictly enforce jury trial waivers unless the cause of the unintentional waiver was something more than mere inadvertence or oversight.

Just as the standards for jury waiver vary among state courts, they also vary among the federal circuits. Filing a bankruptcy case in Delaware or Florida will bring differing standards and procedures into play. But the point remains. Whether your client wishes to protect its right to a jury trial in state court or enforce the debtor's waiver of that same right, the alternative forums may entail different rules, and the implications of removal or remand should be considered before quickly deciding to contest bankruptcy court jurisdiction.

The specialized experience of bankruptcy judges is also worth pondering. State judges are generally picked from a talent pool that spans the legal spectrum. Regardless of the nature of your litigation, you might find yourself before a judge with a background in family law, trusts and estates, or criminal law. Bankruptcy court judges, by contrast, are usually drawn from the world of bankruptcy practitioners—and even the exceptions are usually lawyers who specialized in corporate law. Because most of the bankruptcy docket consists of business or financial disputes, bankruptcy judges have significant experience in the areas of law that arise most frequently in commercial cases.

Of course, certainty is always preferable to generalization, and it may be possible to learn a great deal about your bankruptcy judge's experience with certain areas of law. Bankruptcy court judges publish opinions—some far more frequently than others—and a quick Lexis or Westlaw search can provide information about past rulings that might suggest the leanings of a particular judge, whereas similar information about state court



judges is usually obtained from rumors, online blogs, and the occasional appellate decision.

Another factor is whether any bankruptcy case is likely to be consolidated with other litigation. In most cases, a plaintiff in litigation that has been removed to bankruptcy court will be a creditor in that defendant/debtor's bankruptcy case, and that status alone may lead to additional proceedings in the bankruptcy court.

For example, if the litigation involves claims that might be eligible for an exception to the debtor's discharge—claims such as fraud and breach of fiduciary duty, which can be deemed excepted from the bankruptcy discharge—the creditor may wish to file an action in bankruptcy court seeking an exception to the discharge pursuant to 11 U.S.C. § 523 (a "523 action"). This will allow any judgment to survive the bankruptcy case.

A 523 action can take many forms. Where sufficient findings of fraudulent conduct are made in another court's rulings or judgment, the bankruptcy court may resolve the matter on summary judgment. Absent such findings, the matter may go to trial so the bankruptcy court can determine for itself whether or not the debt arises from sufficiently fraudulent conduct. If the removed state court litigation involves such claims, there may be advantages in having both actions proceed to judgment before the same bankruptcy judge. That will ensure the bankruptcy court is fully apprised of what the defendant did to cause the debt.

As noted above, a debtor's entire financial and legal circumstances are laid out before a bankruptcy judge in the course of bankruptcy proceedings. And where the litigation involves allegations under section 523 of malicious intent, fraud, breach of fiduciary duty, and other such categories of conduct, there may be substantial advantages in having the bankruptcy judge determine both the underlying litigation and the 523 action—including reduced costs and a greater certainty of consistent rulings.

Nor should settlement be ignored when deciding on remand. In many cases, the filing of a bankruptcy case, the removal of litigation, and the responsive efforts to obtain remand to state court are simply steps in a complicated struggle for settlement leverage. And while the automatic response to removal of litigation to bankruptcy court might be to assume that remand will restore prior settlement positions, in fact it has usually altered the playing field.

It may be possible, at the outset of the bankruptcy case, to gain an understanding of what a judgment will be worth against the debtor/defendant. For example, is it a case likely to pay only pennies on the dollar, or would the expected judgment be a likely candidate for a 523 action? It would be wise to consider the full litigation landscape faced by the debtor, whether there are activist creditors who might seek appointment of a trustee, and whether the debtor's case might be converted to a different chapter under the code—that is, from a Chapter 11 reorganization to a Chapter 7 liquidation. The answers to questions like these will help decide whether to pursue remand.

For example, if the potential judgment is for a pure contract claim that likely would be discharged in a Chapter 7 liquidation, there is little point to incurring fees on a motion for remand. On the other hand, if your litigation involves allegations of financial improprieties by the debtor, the debtor might be far more willing to see the matter settled than have evidence of such improprieties laid out before the bankruptcy judge. Unless there is a pending trial date that must be saved by immediate remand, it is worth taking the time to answer these questions and weigh the relative advantages of each forum.

Finally, it is important to remember that not all defendants who file bankruptcy immediately remove litigation to bankruptcy court. They may find far more potential for delay in an alternative strategy. Filing a bankruptcy petition automatically stays state court litigation, and the time it could take to obtain relief from the automatic stay in bankruptcy court is similar to the time it could take to obtain remand. But a debtor can remove litigation to bankruptcy court not only following the filing of the bankruptcy petition (within 90 days) but also following the subsequent entry of an order granting relief from the automatic stay (within 30 days). For example, if the debtor does not remove the action, and the non-debtor litigant obtains relief from the automatic stay to allow the state court litigation to proceed, the debtor has a second opportunity to remove the litigation to bankruptcy court within 30 days. As a result, where delay is a debtor's goal, the debtor might employ a two-step approach of first filing the petition and then removing the litigation only after the automatic stay has been lifted, to further push back a return to the state court's trial calendar.

In this scenario, or any scenario where the debtor has not chosen to remove the litigation to bankruptcy court, the non-debtor litigants should consider whether removal is in their own interests. Each of the reasons described above, among others specific to the particular case, may apply, whether the analysis is made after a debtor has removed the litigation or while a non-debtor is considering doing so. Indeed, a debtor's decision to leave litigation in state court may reflect a recognition that a bankruptcy judge likely to learn of the debtor's history and practices would favor the adversary's interests in the litigation.

Bankruptcy judges have significant experience in the areas of law that arise most frequently in commercial cases.

None of this should be taken as an argument in favor of bankruptcy court jurisdiction in all, or even most, cases. Many practitioners will favor the state court judge they know over an unfamiliar judge in bankruptcy court. Many clients will be better served by the opportunity to hold a lengthy jury trial in a forum with more experience with jury trials. And in many cases, the removal and remand of state court litigation will present nothing more than a procedural bump in the road to trial.

But in each case, counsel should consider the nature of the debtor, the circumstances of the bankruptcy case, and the likely advantages and disadvantages that the bankruptcy court could offer as an alternative forum for litigation. ■