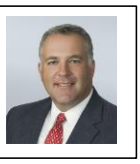
Down but Not Out: Bankruptcy's Effect on Diversity of Citizenship

ABOUT THE AUTHORS



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I. Introduction

Many litigation practitioners are rightfully uncertain of how a party's bankruptcy filing affects the rules governing diversity of citizenship jurisdiction, removal and remand, and the doctrine of fraudulent joinder. Many practitioners wrongfully believe that a bankrupt party does not affect the analysis of whether diversity exists, when in fact it may. The issue is whether the citizenship of the bankrupt party matters if it is the only party that defeats diversity.

II. Fraudulent Joinder[1]

Aside from the basic rules governing diversity of citizenship, removal and remand, the main issues raised by this question relates to the doctrine of fraudulent joinder, which permits the court in certain instances to disregard the presence of a non-diverse defendant for purposes of determining diversity.[2]

Establishing fraudulent joinder in most jurisdictions is generally premised upon one of two things: (1) fraud in the plaintiff's pleading of jurisdictional facts or (2) a showing that there is no possibility that the plaintiff could establish a cause of action against the in-state defendant in state court.[3] In the vast majority of cases, the battleground for fraudulent joinder turns on whether the plaintiff can establish any possibility of maintaining the action against the non-diverse defendant. Certain affirmative defenses, such as the statute of limitations or some kind of immunity, could preclude any showing by plaintiff of a viable cause of action against the non-diverse defendant.

However, the party alleging fraudulent joinder bears a "heavy burden," with all issues of fact and law to be resolved in plaintiff's favor.[4] Some jurisdictions even apply a clear and convincing evidence standard to allegations of fraudulent joinder.[5] In considering the issue, the court "is not bound by the allegations of the pleadings, but may instead consider the entire record, and determine the basis of joinder by any means available."[6] All doubts about the propriety of removal based upon an alleged fraudulent joinder should be resolved in favor of retained state court jurisdiction.[7] In sum, the Court's inquiry is limited to whether the plaintiff has demonstrated even a "glimmer of hope" in sustaining a claim against the bankrupt defendant."[8] The Fourth Circuit has specifically held that "[t]he district court erred by delving too far into the merits in deciding a jurisdictional question."[9]

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[1] Fraudulent joinder should not be confused with the more recent and oft-criticized concept of "fraudulent misjoinder" which exists when a plaintiff sues a diverse defendant in state court and joins a viable claim involving a non-diverse party even though the plaintiff has no reasonable basis to join them both in one action because the claims bear no relation to each other. In such cases, some courts have concluded that diversity is not defeated where the claim that destroys diversity has no real connection with the claim that would qualify for diversity jurisdiction. *See Tapscott v. MS Dealer Serv. Corp.*, 77 F.3d 1353, 1360 (11th Cir. 1996), *abrogated on other grounds by Cohen v. Office Depot, Inc.*, 204 F.3d 1069 (11th Cir. 2000).

[2] *See Mayes v. Rapoport*, 198 F.3d 457, 461 (4th Cir. 1999) (citing *Cobb v. Delta Exports, Inc.*, 186 F.3d 675, 677-78 (5th Cir. 1999)).

[3] *See, e.g. Marshall v. Manville Sales Corp.*, 6 F.3d 229, 232 (4th Cir. 1993) (citing *B., Inc. v. Miller Brewing Co.*, 663 F.2d 545, 549 (5th Cir. 1981)); *Henderson v. Washington Nat. Ins. Co.*, 454 F.3d 1278, 1281 (11th Cir. 2006) (citation omitted); *see also Alexander v. Elec. Data Sys. Corp.*, 13 F.3d 940, 949 (6th Cir. 1994) (citation omitted); *Filla v. Norfolk S. Ry. Co.*, 336 F.3d 806, 809-10 (8th Cir. 2003).

[4] *Hartley v. CSX Transp., Inc.*, 187 F.3d 422, 424 (4th Cir. 1999) (citation omitted); *Poulos v. Naas Foods, Inc.*, 959 F.2d 69, 73 (7th Cir. 1992) (citation omitted).

[5] *See Henderson*, 454 F.3d at 1281 (citing *Parks v. New York Times Co.*, 308 F.2d 474, 478 (5th Cir. 1962) (citations omitted)).

[6] *Mayes*, 198 F.3d at 464 (citation omitted); *Dodd v. Fawcett Publ'ns, Inc.*, 329 F.2d 82, 85 (10th Cir. 1964) (citation omitted).

[7] *See Marshall*, 6 F.3d at 232 (citing *Am. Fire & Cas. Co. v. Finn*, 341 U.S. 6, 10 (1951)).

[8] *Hartley*, 187 F.3d at 426.

[9] *Id*. at 425.

In practice, parties seeking removal on the basis of an alleged fraudulent joinder because the non-diverse defendant is bankrupt will generally argue that such party is a nominal or dispensable party against whom the plaintiff has no chance of recovering. However, the automatic stay triggered by a party's petition for bankruptcy is not tantamount to dismissal of the defendant from the case.[10] The mere fact that a defendant filed bankruptcy does not mean that the plaintiff cannot establish its claims against the defendant or that the defendant is not liable to the plaintiff for its alleged debts as a matter of law.[11]

As applied to the bankrupt defendant, it is the plaintiff's intent to obtain a judgment against the non-diverse (and bankrupt) defendant, and not whether it can ultimately collect the judgment, that is controlling on the issue of fraudulent joinder.[12] More importantly, "[e]ven if a defendant has been joined solely to prevent removal, such joinder is not fraudulent if the plaintiff does have a claim against the resident defendants."[13] Thus, the plaintiff's motive is immaterial so long as there is a valid claim against the non-diverse defendant and no fraud taints the pleading. This principle has been long recognized by our nation's highest court.[14] The bankrupt party should be treated the same as any other party unless a fraudulent joinder can be proven.[15]

To bolster the plaintiff's case, plaintiff's counsel should apply to the relevant Bankruptcy Court for a Relief from Stay to allow the plaintiff to proceed against the bankrupt party. The relief from stay need only allow the pursuit of claims, not necessarily the collection of judgments. Many Bankruptcy Courts will reserve ruling on questions of collection or enforcement and require the plaintiff to re-petition the Bankruptcy Court to take further action beyond the prosecution of the case. These limitations do not convert the bankrupt party into a "sham" defendant. By obtaining relief from stay the plaintiff has a cognizable claim against the bankrupt defendant sufficient to overcome a motion alleging fraudulent joinder and seeking remand.[16]

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[10] *See Sutton Woodworking Machine Co., Inc. v. Mareen-Johnson Machine Co.*, 328 F.Supp.2d 601, 607 (M.D.N.C. 2004) (citing *Stewart v. A.G. Edwards & Sons, Inc.*, 74 B.R. 26, 27 (D.S.C. 1987)); *see also David v. Hooker*, 560 F.2d 412, 418 (9th Cir. 1977) ("a stay of a suit pending in another court against the bankrupt is not a dismissal of the suit nor does it deprive the court of jurisdiction over the matter; it merely suspends the proceedings.").

[11] *See id*.

[12] *See Storr Office Supply Div. v. Radar Bus. Sys.-Raleigh, Inc.*, 832 F.Supp. 154, 157 (E.D.N.C. 1993) (discussing *Nosonowitz v. Allegheny Beverage Corp.*, 463 F.Supp. 162, 163 (S.D.N.Y. 1978)).

[13] *Nosonowitz*, 463 F.Supp. at 164 (citation omitted).

[14] *See Chicago, R. I. & P. Ry. Co. v. Schwyhart*, 227 U.S. 184, 193 (1913) ("the motive of the plaintiff, taken by itself, does not affect the right to remove. If there is a joint liability, he has an absolute right to enforce it … Hence the fact that the [diversity defendant] is rich and [the non-diversity defendant] poor does not affect the case."); *see also Mecom v. Fitzsimmons Drilling Co.*, 284 U.S. 183, 189 (1931) ("in a removal proceeding the motive of a plaintiff in joining defendants is immaterial, provided there is in good faith a cause of action against those joined").

[15] *See generally* cases cited at note 10, *supra.*

[16] *See Rabun v. Honda Motor Co.*, 9:10-cv-584, 2010 WL 3058716 (D.S.C. Aug. 2, 2010) (remanding diversity action to state court even though order lifting stay

As a final note on fraudulent joinder, it should be noted that jurisdictions may take different stances on the doctrine's applicability in the context of joinder that occurs *after* an action is removed.[17] Section 1447(e) provides that "[i]f after removal the plaintiff seeks to join additional defendants whose joinder would destroy subject matter jurisdiction, the court may deny joinder, or permit joinder and remand the action to the State court."[18] Thus, in the context of a post-removal attempt to join a non-diverse defendant, a district court cannot permit the non-diverse defendant to be joined and also retain jurisdiction, but the doctrine of fraudulent joinder may have some bearing on whether the court denies joinder and retains jurisdiction and allows joinder and remands the case to state court.

III. Conclusion

Jurisdiction is often the first battleground in many complex litigation matters. The analysis of jurisdiction and the existence or non-existence of diversity is a frequently litigated conundrum. Counsel must take the time to perform a careful and complete analysis of the parties and not rush to judgment as to where everyone stands. A party may be down, but not out, for purposes of the diversity equation. When dealing with a bankrupt party it is incumbent on counsel to determine what, if any, remedies may still be available against that party, whether there is a good faith basis to move for full or limited relief from stay, and whether that party's citizenship affects diversity. A short practice pointer, but one that can make all of the difference.

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limited plaintiff to pursuing bankrupt defendant's insurance coverage).

[17] *Compare Cobb v. Delta Exports, Inc.*, 186 F.3d 675, 677 (5th Cir. 1999) ("The fraudulent joinder doctrine does not apply to joinders that occur *after* an action is removed.") (emphasis in original), *with Mayes*, 198 F.3d at 461 ("the fraudulent joinder doctrine can be yet another element of the district court's flexible, broad discretionary approach to resolving a post removal question of whether a non-diverse defendant should be joined under [28 U.S.C. §] 1447(e)").

[18] 28 U.S.C. § 1447(e).