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Does the Equitable Doctrine of Res Judicata Apply to a Bankruptcy Court Order Approving a Settlement With a Bankruptcy Trustee, Thus Prohibiting a Second Lawsuit by a new Bankruptcy Trustee on the Subject Matter of the Earlier Settlement?

This post is written based on the following hypothetical. A husband transfers his ownership in the marital residence to his wife at a point when the husband has no debts and owns other assets; a deed is recorded in the appropriate County Clerk's office and reflects $100 as the price paid by the wife.

Five years later the husband finds himself in substantial debt resulting from a failed business transaction. Looking to clear the debt the husband files a Chapter 7 bankruptcy petition, prompting the Chapter 7 bankruptcy trustee to assert fraudulent transfer claims against the husband and wife arising out of the earlier transfer of ownership in the marital residence. A settlement is reached between the husband, his wife, and the bankruptcy trustee to dispose of the fraudulent transfer claims, the bankruptcy court judge enters an order approving the settlement, and the husband receives a bankruptcy discharge. Many years later the husband finds himself in debt again, and files a second Chapter 7 bankruptcy case. The bankruptcy trustee in the second bankruptcy case files suit challenging the same transfer that was part of the settlement with the other trustee in the earlier litigation.

Does the equitable doctrine of res judicata prohibit the second bankruptcy trustee from re-litigating the earlier settled claims with the first bankruptcy trustee? Obviously, decisions like this require a fact sensitive analysis. I leave the reader to come to his or her own conclusion.

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Res judicata is an equitable doctrine developed under the common law that prevents litigants from getting a "second bite at the apple" by filing a subsequent lawsuit based on claims that were resolved by a judgment entered on the merits in an earlier lawsuit. In re Mullarkey, 536 F.3d 215, 225 (3d Cir. 2008). It also bars claims that could have been brought in a previous action. Id. The doctrine is also known as claim preclusion, and as explained by the United States Supreme Court a prior judgment issued on the merits by a court of competent jurisdiction concludes and extinguishes the entire claim or cause of action in controversy. See Nevada v. United States, 463 U.S. 110, 129 (1983); Heiser v. Woodruff, 327 U.S. 726, 735 (1949); Cromwell v. County of Sac, 94 U.S. 351, 352-353 (1877).

In other words, the *res judicata* doctrine bars not only claims that were brought in a previous action, but also prohibits claims that could have been brought. Post v. Hartford Ins. Co., 501 F.3d 154, 169 (3d Cir. 2007). It "protect[s] litigants from the burden of relitigating an identical issue with the same party or his privy and ... promot[es] judicial economy by preventing needless litigation." Id. Accord Elkadrawy v. Vanguard Grp., Inc., 584 F.3d 169, 174 (3d Cir. 2009) ("A claim extinguished by res judicata 'includes all rights of the plaintiff to remedies against the defendant with respect to all or any part of the transaction or series of connected transactions, out of which the action arose.'")(Internal citation omitted); Churchill v. Star Enters., 183 F.3d 184, 195 (3d Cir. 1999)(dismissing under *res judicata* a second action pleading different legal theories and new facts because of the essential similarity of the underlying events with a prior lawsuit).

The preclusive effect of a prior federal court judgment is controlled by federal *res judicata* rules. See Burlington Northern Railroad Co. v. Hyundai Merchant Marine Co., Ltd., 63 F.3d 1227, 1231 (3d Cir. 1995); Agilectric Power Partners, Ltd. v. General Electric, Co., 20 F.3d 663, 664 (5th Cir. 1994); Barnett v. Stern, 909 F.2d 973, 977 (7th Cir. 1990); Steve D. Thompson Trucking, Inc. v. Dorsey Trailers, Inc., 870 F.2d 1044, 1045 (5th Cir. 1989).

While the complications of a bankruptcy case may make the application of *res judicata* somewhat more complex than in other non-bankruptcy contexts, the doctrine is fully applicable to bankruptcy court decisions. See Katchen v. Landy, 382 U.S. 323, 334 (1966). NovaCare Holdings, Inc. v. Mariner Post-Acute Network, Inc. (In re Mariner Post-Acute Network, Inc.), 267 B.R. 46, 52-53 (Bankr. D.Del. 2001); In re Target Industries, 328 B.R. 99 (Bankr. D.N.J. 2005) (stating that "bankruptcy cases require a careful application of res judicata."). As the court in Target Industries noted, "[a]lthough the first two prongs of the doctrine will usually be readily apparent, the third prong, whether the present suit is based on the previous cause of action, is usually far less clear." Id. at 116.

Federal law applies *res judicata* when three elements are met: (1) a final judgment on the merits, (2) the same parties or their privies, and (3) a later suit based on the same cause of action. Mullarkey, 536 F.3d at 225; Board of Trustees of Trucking Employees of North Jersey Welfare Fund, Inc., v. Centra, 983 F.2d 495, 504 (3d Cir.

1992). When all three factors of *res judicata* are present, "a claim that was or could have been raised previously must be dismissed as precluded." CoreStates Bank, N.A. v. Huls Am., Inc., 176 F.3d 187, 194 (3d Cir. 1999). (Emphasis added).

Final Judgment on the Merits

"Generally, a court-approved settlement receives the same res judicata effect as a litigated judgment." In re Medomak Canning, 922 F.2d 895, 900 (1st Cir. 1990). In bankruptcy proceedings, "an order which disposes of a 'discrete dispute within the larger case' [is] considered final and appealable." In re American Colonial Broadcasting Corp., 758 F.2d 794, 801 (1st Cir. 1985) (quoting In re Saco Local Development Corp., 711 F.2d 441, 444 (1st Cir. 1983)); In re Prof'l Ins. Mgmt., 285 F.3d 268, 279, 281 (3d Cir. 2002) (quoting In re Moody, 817 F.2d 365, 367-68 (5th Cir. 1987)("[A] bankruptcy court order ending a separate adversary proceeding is appealable as a final order even though that order does not conclude the entire bankruptcy case.")). Accord In re Patel, 43 B.R. 500, 503 (N.D. Ill. 1984) ("bankruptcy court order approving a settlement is final and appealable under [28 U.S.C.] § 1334(a) because it determines the rights of the parties to the settlement"); In re Gibraltar Res., Inc., 210 F.3d 573, 576 (5th Cir. 2000) ("A bankruptcy court's approval of a settlement order that brings to an end litigation between parties is a 'final' order . . . A settlement agreement approved and embodied in a judgment by a court is 'entitled to full res judicata effect.'").

Most recently, in an unpublished decision issued by the United States District Court for the Southern District of New York, a district judge held that a bankruptcy court order approving a trustee's settlement constitutes a final judgment on the merits for *res judicata* purposes. Cho v. Seventh Avenue Fine Foods Corp., 2016 U.S. Dist. LEXIS 56603)(S.D.N.Y. April 28, 2016).

Privity Between Parties

Privity exists for purposes of *res judicata* where two parties represent the interests of the same entity, and this relationship may exist between a creditor and a trustee in some cases. *See* In re Dominelli, 820 F.2d 313 (9th Cir.1987). A party is considered to be in privity to a prior party when the party to the prior litigation represented the same legal right applied to the same subject matter. Jefferson School v. Subversive Activities Control Bd., 331 F.2d 76, 83 (D.C. Cir. 1963)(citing Hart Steel Co. v. Railroad Supply Co., 244 U.S. 294 (1917)). As one federal jurist remarked: "privity states no reason for including or excluding one from the estoppel of a judgment. It is merely a word used to say that the relationship between the one who is a party on the record and another is close enough to include that other within the res judicata." Bruszewski v. United States, 181 F.2d 419, 423 (3d Cir. 1950) (Goodrich, J., concurring), cert. denied, 340 U.S. 865 (1950).

(i) Trustee as Successor to Debtor's Property

It has been recognized that "[t]he trustee in bankruptcy is a successor to the bankrupt's property and for many purposes is deemed in privity with the bankrupt." Matter of Good Time Charley's, Inc., 54 B.R. 157, 160 (Bankr. D.N.J. 1984)(quoting Edleman v. McMullin Orchards (In the Matter of Silver Mill Frozen Foods, Inc.), 32 B.R. 783, 785 (Bankr. W.D.Mich.1983)). A trustee in bankruptcy, including a debtor-in-possession, may be considered the privy of the pre-bankruptcy debtor for *res judicata* purposes. Taylor v. Sturgell, 553 U.S. 880, 892 (2008). Thus, it is well settled that where the trustee in bankruptcy unsuccessfully litigates an issue outside the bankruptcy court the decision against him is binding in the bankruptcy court. Heiser v. Woodruff, 327 U.S. 727 (1946); Fischer v. Pauline Oil Co., 309 U.S. 294 (1940); Davis v. Friedlander, 104 U.S. 570 (1881). Likewise, it follows that when a bankruptcy trustee litigates a matter in bankruptcy court the decision is binding in a subsequent bankruptcy filing of the same debtor. See e.g., In re Crasper, 142 B.R. 396 (Bankr. D. Idaho 1992)(holding that default judgment previously entered in the debtor's earlier Chapter 7 bankruptcy was *res judicata* as to the debts listed in that proceeding).

(ii) Res Judicata Applies to Nonparties

The Third Circuit Court of Appeals has recognized that *res judicata* can apply to nonparties if privity existed between the prior and present litigants - so called "nonparty preclusion." In re Montgomery Ward, LLC, 634 F.3d 732 (3d Cir. 2011). Indeed, it is well established that collateral estoppel, the issue preclusion component within the larger doctrine of *res judicata*, applies where a nonparty is in privity with someone who was a party to the prior suit. Richards v. Jefferson County, Ala., 517 U.S. 793, 798-799 (1996). Among the exceptions to the general rule against non-party preclusion is where a special statutory scheme, such as bankruptcy, expressly forecloses subsequent litigation. Taylor, supra, 553 U.S. at 893-896. See Nationwide Mut. Fire Ins. Co. v. Hamilton, 571 F.3d 299, 311 n.13 (3d Cir. 2009)("We have observed that 'privity states no reason for including or excluding one from the estoppel of a judgment. It is merely a word used to say that the relationship between the one who is a party on the record and another is close enough to include that other within the res judicata.'"). As noted in M. Ericsson Telecommunications, Inc. v. Teltronics Services, Inc. (In re Teltronics Services, Inc.), 18 B.R. 705, 706 (E.D.N.Y.1982), "[s]ubstance rather than form determines the scope of identity of parties."

Same Cause of Action

Causes of action are the same when there is an “essential similarity of the underlying events giving rise to the various legal claims.” CoreStates Bank, supra, 176 F.3d at 194) (quoting United States v. Athlone Indus., 746 F.2d 977, 984 (3d Cir. 1984)); Churchill, supra, 183 F.3d at 194; Lubrizol Corp. v. Exxon Corp., 929 F.2d 960, 961 n.1 (3d Cir. 1991).

The Third Circuit takes a broad view of what encompasses the same cause of action, "focusing on the underlying events of the two actions." Id. In reviewing whether the suits involve the same causes of action, a court should consider:

(1) whether the acts complained of and the demand for relief are the same (that is, whether the wrong for which redress is sought is the same in both actions);
(2) whether the theory of recovery is the same;
(3) whether the witnesses and documents necessary at trial are the same (that is, whether the same evidence necessary to maintain the second action would have been sufficient to support the first); and
(4) whether the material facts alleged are the same.

Athlone Indus., 183 F.3d at 984. See also Sheridan v. NGK Metals Corp., 609 F.3d 239, 260 (3d Cir. 2010) ("We '[do] not apply this conceptual test mechanically,' but 'focus on the central purpose of the doctrine, to require a plaintiff to present all claims arising out [of] the same occurrence in a single suit.'")(quoting Churchill, supra, 183 F.3d at 194)). A party's reliance on different statutes, assertion of different theories of recovery, or seeking of different relief in each action is not dispositive for *res judicata* purposes. Athlone Indus., supra, 746 F.2d at 984.

"Within the Third Circuit, a cause of action should be barred only where 'the factual underpinnings, theory of the case, and relief sought against the parties to the proceeding are so close to a claim actually litigated in the bankruptcy that it would be unreasonable not to have brought them both at the same time in the bankruptcy forum.'" Eastern Minerals & Chemicals Co. v. Mahan, 225 F.3d 330, 337-38 (3d Cir. 2000).*

This article is written for informational purposes only, and describes a hypothetical scenario that would be litigated in the United States Bankruptcy Court for the District of New Jersey, which is part of the Third Circuit.. It should not be construed as an exhaustive treatise on the subject matter. Nor does this article establish an attorney-client relationship with LoFaro & Reiser, L.L.P.