Defendant in Personal Injury Action Files for Bankruptcy – Now What?

By Jeffrey Traurig, Esq.

Most attorneys representing personal injury claimants undoubtedly will come across at least one matter where the defendant commences a bankruptcy case under the Bankruptcy Code.[1] When an attorney finds out that a defendant has filed for bankruptcy protection, immediate steps should be taken to ensure that the interests of both the client and the attorney are protected.

The Bankruptcy Code is a federal law but courts in different circuits will from time to time apply it differently. This article is intended to give an overview of some of the issues facing personal injury claimants in the Second and Third Circuits when a defendant commences a bankruptcy case.

As general background, the Bankruptcy Code establishes a framework by which a debtor can discharge (i.e. dispose) of claims and establishes a priority scheme for claims to be paid from a debtor's assets. In a Chapter 7 bankruptcy case, distributions to creditors are made by a trustee in accordance with section 726 of the Bankruptcy Code.[2] In Chapter 11 cases, distributions are made in accordance with the terms of a "plan" approved by creditors and the Bankruptcy Court.[3] Personal injury claims arising before the bankruptcy case are unsecured claims that are generally paid after secured claims, post-petition claims and a variety of other priority claims.[4]

To ensure that the debtor has the opportunity to obtain a "fresh start," when a bankruptcy case is filed, Section 362(a) of the Bankruptcy Code imposes an automatic stay on most actions against the debtor.[5] The automatic stay, among other things, holds in abeyance the collection or recovery of assets from the debtor's estate and halts the commencement and continuation of judicial or other actions or proceedings that were commenced or could have been commenced against the debtor before the bankruptcy case.

An attorney may find out about a bankruptcy filing through a number of sources, including notices filed and served either in the state court or bankruptcy court. It is also possible that an attorney will not receive direct notice from the debtor but may only hear about the case from notices sent to the client or through publication notice or other publicity. Regardless of the source, once on notice, the attorney must comply with the automatic stay. In addition, actions taken in violation of the stay – even without notice of the bankruptcy – are generally void *ab initio* and of no force and effect in the Second and Third Circuits.[6]

If the debtor is an individual, violations of the automatic stay are subject to sanctions under Section 362(k) of the Bankruptcy Code, which provides that the individual may recover actual damages, including attorneys' fees, and even punitive damages in appropriate circumstances.[7] There is a split among the circuits as to whether sanctions under Section 362(k) only apply to debtors that are individuals or whether it is extended to debtor corporations.[8] However, even in the Second Circuit where sanctions under Section 362(k) are limited to individuals, a Bankruptcy Court may still use its general contempt power to punish violations of the automatic stay.[9]

There are a number of steps that can be taken to preserve a personal injury claimant's rights to receive distributions from a debtor's bankruptcy estate. Under the right circumstances, relief from the automatic stay may also be granted by a Bankruptcy Court so that personal injury claims can be liquidated and a claimant may even be allowed to collect from available insurance while a bankruptcy case is pending. It is important that notices and other bankruptcy papers be reviewed to ensure that a claimant's rights are not being impaired by, among other things, modifications to the automatic stay or provisions in a Chapter 11 plan that could have a *res judicata* effect.

BANKRUPTCY CLAIMS

Claims in bankruptcy are broadly defined; they can arise before a lawsuit is commenced and may even arise before an injury is known. Section 101(5) of the Bankruptcy Code defines a claim as, among other things, "the right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured or unsecured . . ." While most courts have consistently interpreted the definition of "claims" broadly to include claims that have not fully accrued, the Court of Appeals for the Third Circuit had historically applied a narrow test to the term "claim" and held that the claim must have "accrued" to be considered a pre-bankruptcy claim.[10] Despite being roundly criticized, this narrow analysis had been the law of the Third Circuit until the issue was revisited in June 2010 in Jeld-Wen, Inc. v. Van Brunt (In re Grossman's Inc.), 607 F.3d 114 (3d Cir. 2010). In Jeld-Wen, the

Court held that with respect to an asbestos claimant, the claim arose at the time of exposure even though the injury did not manifest itself until after the bankruptcy. While the Jeld-Wen decision did not address the impact of due process and proper notice, it applied a broad definition of claim, thus requiring claimants to timely take steps to protect their interests or risk losing any ability to recover from the debtor.

PROOF OF CLAIM

Claims can only receive distributions from a debtor's estate if a "proof of claim" is timely filed in accordance with the Federal Rules of Bankruptcy Procedure. In a Chapter 7 case, if there are assets for distribution, a proof of claim must be filed before the proof of claim deadline regardless of whether a claim is scheduled as undisputed. In a Chapter 11 case, it may not be necessary to file a proof of claim if the debtor lists the creditor as an undisputed, non-contingent liquidated claim in the schedules filed with the Court.

If assets are, or may be, available for distribution to creditors holding pre-bankruptcy claims, a deadline to file "proof of claim" will be established and notice of the deadline should be sent to all known creditors by the debtor, the court, or a court-appointed noticing agent. While notice of the proof of claim deadline should be sent to all known claimants, not all debtors' books and records are reliable or up to date with the most current creditor information. Accordingly, it is common practice in large debtor cases, as well as many smaller cases, for debtors to provide constructive notice to unknown creditors by publishing in newspapers the notice of the proof of claim filing deadline. The United States Bankruptcy Court for the Eastern District of New York held that publication notice was sufficient notice to a claimant that had previously requested medical records.[11] The Bankruptcy Court reasoned that the claimant's request for medical records was not sufficient to put the debtor on notice of an actual claim. Accordingly, after considering other factors, the Bankruptcy Court denied the claimant's request to file a late claim.

A proof of claim must be filed using an official proof of claim form.[12] The official claim form can be obtained from bankruptcy courts' websites and, in many cases, the debtor will send an official proof of claim form to known creditors. In some cases, information regarding a personal injury claimant may even be printed on the claim form, specifically identifying the claimant. Notwithstanding the fact that a debtor has knowledge of a creditor *(continued on page 69)*

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or has pre-printed a proof of claim form with the creditor's claim information, a proof of claim form for disputed personal injury claims still must be completed, executed, and returned to preserve the claimant's right to receive distributions from a debtor.[13] Although the official proof of claim form is only a one page document, it requires that supporting documentation be provided for the claim to be *prima facie* valid.[14] Accordingly, it is generally good practice to attach a copy of the summons and complaint to the proof of claim. If a complaint has not been filed, the creditor should provide background information regarding the basis for the claim in an addendum to the proof of claim.

The debtor may also seek to have the stay lifted to allow the claim to be liquidated in state court or provide another procedure for liquidating personal injury claims, including court directed mediations, because the bankruptcy court's jurisdiction to adjudicate and allow personal injury claims is limited. There is no requirement that a creditor file a motion seeking to modify the automatic stay.

MODIFYING THE AUTOMATIC STAY TO PROCEED AGAINST INSURANCE

While Section 362(a) of the Bankruptcy Code imposes a stay on actions against the debtor, it is not always necessary to wait what could be years until the end of a bankruptcy case before proceeding with litigation to recover compensation for injuries.

Section 362(d) provides that "on request of a party in interest and after notice and a hearing," the stay may be modified for "cause."[15] The Bankruptcy Code does not define cause and courts have established various factors for determining whether cause exists to lift the automatic stay. For instance, courts in the Second Circuit generally follow a twelve factor balancing test: (1) whether relief would result in a partial or complete resolution of the issues; (2) lack of any connection with or interference with the bankruptcy case; (3) whether the other proceeding involves the debtor as a fiduciary; (4) whether a specialized tribunal with the necessary expertise has been established to hear the cause of action; (5) whether the debtor's insurer has assumed full responsibility for defending it; (6) whether the action primarily involves third parties; (7) whether litigation in another forum would prejudice the interests of other creditors; (8) whether the judgment claim

arising from the other action is subject to equitable subordination; (9) whether movant's success in the other proceeding would result in a judicial lien avoidable by the debtor; (10) the interests of judicial economy and the expeditious and economical resolution of litigation; (11) whether the parties are ready for trial in the other proceeding; and (12) impact of the stay on the parties and the balance of harms.[16]

Bankruptcy Courts in the Third Circuit generally consider three primary factors in determining whether to grant a claimant relief from the automatic stay. The factors are: (1) whether continuation of the civil action will greatly prejudice either the bankrupt estate or the debtor; (2) whether the hardship to the claimant would considerably outweigh the hardship to the debtor if the stay remained in place; and (3) whether the claimant has a probability of succeeding on the merits.[17]

Because prejudice against a debtor is one of the primary factors in any balancing test, one of the factual issues that weighs heavily in determining whether the automatic stay should be lifted for a personal injury action to proceed is whether insurance is available to satisfy the claim and whether the debtor would be required to pay defense costs or deductibles. If a debtor has sufficient third party commercial coverage with no deductible (or a deductible that has already been met) and if the insurance carrier is responsible for all defense costs with no premium adjustment, it is likely that a bankruptcy court would authorize the lifting of the automatic stay to permit the claimant to proceed against insurance.

On the other hand, if the debtor is responsible for defense costs and deductibles, or if insurance will not satisfy the claim in full, the court will need to balance the factors to determine whether the stay should be lifted, including whether there is a likelihood that pre-petition unsecured creditors will receive distributions in the bankruptcy case and the ultimate need for the claim to be liquidated, as well as whether the claimant will agree to waive claims against the debtor's estate if insurance is not adequate.

EXTENSION OF STATUTE OF LIMITATIONS

As a result of the commencement of a bankruptcy case and the imposition of the automatic stay, the statute of limitations may be extended. It is important to note however that the statute of limitations is not tolled (i.e. it does not stop and restart). The distinction is important because the statute of limitations will expire on the later of (a) the time in which the statute of limitations ordinarily would have run, or (b) 30 days after notice of the termination or expiration of the stay. See 11 U.S.C. § 108(c). In other words, if the statute of limitations expires while the stay is in effect or within the first 30 days after notice that the automatic stay terminated or expired, a personal injury claimant will only have 30 days after notice of the termination or expiration of the stay to file a complaint (even if a proof of claim has been filed). A debtor that is interested in restarting the statute of limitations should provide written notice that the stay has been lifted.

The Bankruptcy Code does not extend the statute of limitations for non-debtors. Accordingly, if the statute of limitations will expire with respect to a non-debtor defendant, a lawsuit against the non-debtor should be commenced before the statute of limitations expires with respect to such defendant. In contrast, naming the debtor with knowledge of the bankruptcy case is a knowing violation of the automatic stay. Further, naming the debtor may be meaningless.

Regardless of whether notice of the bankruptcy stay was provided before the complaint was filed, the stay is in effect and violations of the stay are generally void *ab initio* in the Second and Third Circuits. However, the issue of whether the mere filing of a complaint is void *ab initio* is the subject of debate and litigation.

Thus, if an action is commenced and a summons and complaint are served on the debtor after the bankruptcy petition date, the mere filing of the action may be void.[18] The Fourth Department in New York has gone so far as to hold that after the automatic stay is terminated,[19] the complaint must be re-filed and re-served with a new index number (although the case before the Fourth Department only involved debtors and defendants and did not address whether a distinction would exist if the index number was validly purchased against other non-debtor defendants and then re-filed).[20] In contrast, some courts have explicitly distinguished the mere filing of a complaint and service and summons from cases where more than just the filing of a complaint and serving of a summons occurred. The Second Department in New York distinguished the mere commencement of an action when there was no notice of the bankruptcy from a case where further actions violated the stay resulting in an order being entered, and indicated that the mere commencement would not be treated as a nullity.[21] The distinction among departments continues to result in litigation because some defendants will argue that a complaint is not valid if filed in violation of the stay. To avoid disputes and costs of litigation, attorneys should consider re-filing complaints and obtaining a new index number, especially when only the debtor is

named as a defendant.

In addition, an attorney may want to, from time to time, monitor the bankruptcy case by reviewing the docket, which is available online with a PACER account – although there is no obligation to do so under the Bankruptcy Code.[22]

PROCEEDING AGAINST DEBTOR AFTER DISCHARGE AND PLAN CONFIRMATION

Distributions to creditors in Chapter 7 bankruptcy cases are made in accordance with the priorities set forth in Section 726 of the Bankruptcy Code.[23] In Chapter 11 cases, distributions are made in accordance with the terms of a plan. It is rare that general unsecured creditors are paid the full amount of their allowed claim from a debtor's bankruptcy estate. Nevertheless, if insurance is available, personal injury claimants may be able to recover from insurance even after a debtor obtains a discharge of its obligations.

Under New York State Insurance Law §3420, general liability insurance policies must include a provision that the insolvency or bankruptcy of the person insured "shall not release the insurer from the payment of damages for injury sustained or loss occasioned during the life of and within the coverage of such policy or contract."

It is well established in the Second Circuit that a personal injury claimant can generally proceed against a discharged debtor, as a nominal defendant, to obtain available insurance.[24] In Green v. Welsh, a tort claimant holding a pre-petition claim against discharged Chapter 7 debtors, arising from a fire at the apartment rented by the claimant from the debtors, was allowed to continue a lawsuit that named a discharged debtor in order to seek recovery from the debtor's insurers.[25] One of the Second Circuit's considerations in allowing the lawsuit to continue was that the debtors were unlikely to incur expenses because their Chapter 7 discharge left them free to default, compelling the insurer to pay the costs of litigation.[26]

Although not conclusive, the Green holding may be limited to discharged debtors only when there is no real economic impact on the reorganized debtor. For instance, in DePippo v. Kmart Corp., 335 B.R. 290 (Bankr. S.D.N.Y. 2005) where the debtor was self-insured, the court noted that:

> (1) the plaintiff can maintain the action against the debtor only when it is necessary to establish liability against a third party; (2) the plaintiff can maintain the action against the debtor only if the debtor bears none of the expense of the defense; *and* (3) most important, the plaintiff may not execute on any judgment he may obtain against the debtor, either against the debtor personally, or against his assets.[27]

It is also possible that even if a discharge is granted to the debtor, a claimant's ability to access available insurance from non-debtors may be impacted by the terms of a Chapter 11 plan confirmed by a debtor. In Metz v. Rockefeller Center, Inc. (In re Rockefeller Center Properties), 09-Civ. 4340 (S.D.N.Y. March 16, 2010), the United States District Court for the Southern District of New York held that under a plan confirmed in 1996 that enjoined actions against a debtor's non-debtor affiliates, the plaintiff was barred from nominally naming such affiliates for the purpose of proceeding against available insurance. In 2006, a wrongful death action was commenced in state court against two of a discharged debtor's non-debtor affiliates. The State Court barred the action based on an injunction in the 1996 plan. The plaintiff sought leave from the bankruptcy court to proceed against the non-debtor affiliates for the sole purpose of proceeding against available insurance. The bankruptcy court denied the plaintiff's request to name the non-debtor. On appeal, the District Court for the Southern District of New York held that the injunction contained in the plan of reorganization should be upheld and affirmed the Bankruptcy Court's order. The District Court reasoned that the existence of retrospective insurance premium requirements that remained in force would result in the non-debtor affiliates incurring costs and therefore the plan injunction should not be modified to even nominally name the non-debtor affiliates.[28]

EXCEPTIONS TO DISCHARGE

Pre-bankruptcy claims based on personal injury incidents are generally treated as unsecured claims that can be discharged. Exceptions include claims based on (a) willful and malicious injury by an individual debtor to another entity, and (b) death or personal injury caused by an individual debtor's operation of a motor vehicle, vessel, or aircraft if such operation was unlawful because the debtor was intoxicated from using alcohol, drugs, or other substances.[29] It is important to note that certain objections to discharge must be raised by a claimant by commencing an adversary proceeding in the bankruptcy proceedings in a timely manner shortly after the commencement of the bankruptcy case.

CONCLUSION

While a bankruptcy case may immediately stay certain litigation relating to personal injury claims, it is important that proper steps be taken to ensure that a claimant's rights are protected and that the attorney is properly representing the client, including ensuring that a proof of claim is timely filed and that the statute of limitations does not expire after the termination of the stay. Attorneys should also consider whether they should actively seek to modify the automatic stay to proceed against insurance while the bankruptcy is pending and should review notices and other pleadings filed in the bankruptcy case to ensure that orders are not entered that impair the ability to proceed against available insurance and should consider monitoring the docket in the bankruptcy case. 

1 11 U.S.C. §§ 101 *et seq*.
2 11 U.S.C. § 726.
3 11 U.S.C. §§ 1126 and 1129.
4 Priority claims include, among others, certain wage claims earned during the 180 days preceding the bankruptcy case, certain consumer deposit claims, various tax claims. See 11 U.S.C. § 507.
5 11 U.S.C. § 362.
6 See Hearst Magazines v. Stephen L. Geller Inc., 2009 WL 812039 (S.D.N.Y. 2009) citing Rexnord Holdings, Inc. v. Bidermann, 21 F.3d 522 (2d Cir. 1994); In re Myers, 491 F.3d 120 (3d Cir. 2007).
7 Section 362(k) was designated Section 362(h) prior to 2005.
8 Saratoga Springs Plastic Surgery, P.C. v. Yarinsky (In re Saratoga Springs Plastic Surgery), 172 Fed. Appx. 339 (2d Cir. 2006) citing In re Chateaugay Corp., 920 F.2d 183 (2d Cir. 1990) (sanctions under Section 362 are only appropriate in cases where the debtor is a natural person); Cuffee v. Atlantic Bus. & Comty. Dev. Corp. (In re Atlantic Bus & Comty. Corp.), 901 F.2d 325, 328-329 (3d Cir. 1990) (sanctions applicable in cases with corporate debtors).
9 See A.C.E Elevator Co., Inc. v. Local 1, Int'l Union of Elevator Constructors (In re A.C.E. Elevator Co., Inc.), 2009 WL 3255381, *6 (Bankr. S.D.N.Y. 2009).
10 Avellino & Biens v. M. Frenville Co. (Matter of M. Frenville Co.), 744 F.2d 332 (3d Cir. 1984).
11 See In re Victory Memorial Hospital, (Bankr. EDNY, August 12, 2010) (Case No. 06-44387).
12 See Fed. R. Bankr. P. 3001(a).
13 See Fed. R. Bankr. P. 3002 and 3003.
14 See Fed. R. Bankr. P. 3001(f).
15 11 U.S.C. § 362(d).
16 See Sonnax Industries, Inc. v. Tri Component Products Corp. (In re Sonnax Industries, Inc.), 907 F.2d 1280, 1286 (2d Cir 1990).
17 See Tribune Media Servs. v. Beatty (In re Tribune Co.), 418 B.R. 116 (Bankr. Del. 2009) citing Izzarelli v. Rexene Products Co. (In re Rexene Products Co.), 141 B.R. 574, 576 (Bankr.D.Del.1992).
18 See Levant v. Nat'l Car Rental Inc., 12 A.D.3d 1203, 786 N.Y.S.2d 372 (First Dept. 2004).
19 Unless the Bankruptcy Court orders otherwise, the stay terminates upon the earliest of the time the case is closed, dismissed or when in an individual Chapter 7 case or Chapter 11 case at the time a discharge is granted or denied. See 11 U.S.C. § 362(c). Motions to dismiss a case generally must be served on all known creditors to provide them proper notice.
20 See Storini v. Hortiales, 16 A.D.3d 1110, 792 N.Y.S.2d 750 (Fourth Dept. 2005).
21 See Carr v. McGriff, 8 A.D.3d 420; 781 N.Y.S.2d 34 (Second Dept. 2004); see also Chen v. Dickerson, 847 N.Y.S.2d 334 (Second Dept., 2007) (noting conflict among departments).
22 Information regarding obtaining a PACER account can be found on the Bankruptcy Court's website.
23 11 U.S.C. § 726.
24 Green v. Welsh, 956 F.2d 30 (2d Cir. 1992); Roman v. Hudson Telegraph Assoc., 784 N.Y.S.2d 484, 485 (First Dept., 2004) (standing for the basic proposition that a claim brought for the purpose of establishing a discharged debtor's insurer's liability is not barred); Presutti v. Suss, 678 N.Y.S.2d 187 (Fourth Dept. 1998) (same); Minafri v. United Artists Theatres, Inc., 782 N.Y.S.2d 177, 179 (Sup. C. Westchester Cty. 2004) (same).
25 Green v. Welsh, 956 F.2d at 36.
26 Id. at 34.
27 DePippo v. Kmart Corp., 335 B.R. 290, 298 (Bankr. S.D.N.Y. 2005) (internal citations omitted); see also Hejmanowski v. Bykowicz, et al., 2010 U.S. Dist. LEXIS 2742 (W.D.N.Y. 2010) (granting a motion to dismiss against certain defendants where the bankruptcy plan enjoined actions against the defendants and the defendants were self-insured up to $750,000).
28 Metz v. Rockefeller Center, Inc., et al., case no. 09-4340 (S.D.N.Y. March 16, 2010).
29 11 U.S.C. § 523(6) and (9).

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