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The Injured Plaintiff's Bankruptcy — Pitfalls for the Civil Litigator

We have all had clients who are in desperate straits during the litigation of their civil claim. Many times, these injured men or women have lost their ability to work. In more catastrophic injuries, even an injured worker's spouse is forced to quit his or her job to care for the plaintiff full time. In rare cases, our clients have adequate health and disability insurance to pull them through difficult times. Often clients' injuries leave them destitute. Depending upon the case and client, financial loans secured to the bankruptcy claim are not always an option. Clients sometimes deal with this problem by filing a bankruptcy. If your client files a bankruptcy while litigation is pending, you need to know several things.

Communicate Well

Communicate immediately and openly with debtor's counsel or, if your client filed the bankruptcy *pro se*, with the case's trustee. There is no way around this and no benefit to delay. If the civil litigation or its proceeds are not reported to the trustee, your client could be accused of fraud, which carries civil and criminal penalties.[1] Further, an active civil case becomes property of the bankruptcy estate upon the bankruptcy's filing, which means the trustee becomes the real party in interest.[2] The trustee then has the authority to hire any attorney he or she chooses to continue litigating the civil case.[3] Trustees often hire the same attorney who represented the plaintiff/debtor before the bankruptcy's filing, but you could lose your case if the trustee believes you have been dishonest or evasive about the claim.

Not All Civil Cases Are Affected Equally

Civil litigation proceeds are in danger if they become an asset of the bankruptcy estate, because the trustee can seize the bankruptcy estate's assets in some instances, or the bankruptcy can be dismissed if the asset is not turned over to the trustee. However, the trustee may only seize or force the turnover of bankruptcy assets that are not exempt, so it is important to know whether your case's assets are likely to be exempt.

In Kentucky, a debtor can use federal bankruptcy exemptions. The federal exemptions allow up to $22,975 in personal injury proceeds to be exempt from the bankruptcy estate, which means a trustee cannot seize them.[4] This exemption does not apply to pain and suffering or "actual pecuniary loss," but sister exemptions allow a debtor to protect a payment in compensation of loss of future earnings.[5] Finally, a miscellaneous exemption exists that can protect up to another $12,725 of cash or property the debtor owns.[6] The bankruptcy trustee has the burden of proving that the personal injury exemption applies to pain and suffering or actual pecuniary loss and courts are slow to exclude personal injury proceeds from this exemption.[7] Practically speaking, trustees rarely challenge the application of these exemptions so long as reasonable proof is shown, and a reasonable allocation of settlement proceeds in a settlement agreement would likely be accepted.

Only settlement or judgment proceeds that are actually kept by the debtor need to be exempted. Attorney fees, expenses and case liens do not count toward the exemption limits. Therefore, only cases with significant injuries, or cases that do not involve a personal injury, are likely to result in a judgment or settlement that will become an unexempt asset of the bankruptcy estate.

How the Type of Bankruptcy Affects Your Client's Net Case Award

It is important that your client realizes that different trustees are paid in different ways because all forms of bankruptcy require the debtor to pay a portion of unexempt estate assets to the trustee. If your client's case is likely to result in a payout that is significantly greater than the bankruptcy exemptions, then your client may want to consider filing a Chapter 13 bankruptcy. Although this type of bankruptcy

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requires your client to make regular payments to the Chapter 13 trustee for a three to five year period, your client can be certain that the Chapter 13 trustee will take a certain fee for his or her services and that the fee will be capped. For example, at this time the Chapter 13 trustees are paid fees of 6.2 percent of all payments into a Chapter 13 plan.[8] Since a plan can never require payments that total more than 100 percent of all debts owed, it is easy to calculate a cap on the potential fees that a Chapter 13 trustee could charge even if your services result in a multi-million dollar verdict for your client.

However, in order to be confirmed, a Chapter 13 plan requires monthly payments while the civil litigation is ongoing, and some clients may not be able to afford to do this.[9] Further, if the civil case does not result in a verdict sufficient to pay off certain secured or priority unsecured debts, the Chapter 13 bankruptcy could fail and your client will not get a discharge on all debts. For these reasons, some clients may choose to file a Chapter 7 bankruptcy.

A Chapter 7 bankruptcy presents a danger to the injured plaintiff because the case law is somewhat unsettled as to how much fee a Chapter 7 trustee can claim. While a Chapter 7 trustee's fee is required to be reasonable[10] and is capped by a sliding scale formula that takes a percentage of estate assets,[11] there is no absolute maximum. In 2005, Congress amended the reasonableness statute[12] and Chapter 7 Trustees have since argued that their fees are no longer required to be reasonable and that the sliding scale formula is in fact a congressionally mandated commission. In several reported cases, courts considered a Chapter 7 bankruptcy in which the trustee claimed a large fee after personal injury civil litigation resulted in the only bankruptcy estate asset. To date, most cases have required the trustee's fee to be proportionate to the work the trustee put into the civil litigation, if any.[13] However, other cases have allowed trustees to use an alternative test that could permit disproportionately high fees.[14] Kentucky's federal courts have unsettled case law on this subject, with one court issuing an opinion that considered both reasonableness and the alternative test,[15] while another court is currently considering a Chapter 7 trustee's request for a large fee upon minimal work.[16]

In short, a Chapter 13 may be a safer mathematical bet for your client if one assumes a trustee will always attempt to take the highest fee possible from the injured plaintiff. A Chapter 7 could be a safer bet if one assumes a trustee will a) keep the plaintiff's attorney post-filing, and b) only ask for a reasonable fee based upon his or her work in the case. As case law develops, it will become clear whether Chapter 7 trustees are forced to accept only reasonable fees, and thus how filing bankruptcy will ultimately impact your client's bottom line.

A bankruptcy is a nuclear option. It can affect your contractual relationship with your client and your client's net judgment or settlement. The latter, in turn, can affect a client's willingness to accept a reasonable settlement offer should one be made. While bankruptcy can certainly assist your client with hard financial times that accompany a serious injury, it must not be entered into without careful consideration of other options. Make sure your client talks to a bankruptcy attorney before filing, and make sure that bankruptcy attorney explains to you how the bankruptcy affects the ongoing personal injury case.

Good luck out there.

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1 18 USC §157.
2 11 USC §541.
3 11 USC §327.
4 11 USC § 522(d)(11)(D). This dollar amount is often adjusted, so be sure to check the statute.
5 *Id.* See also 11 USC § 522(d)(11)(E). There is also a wrongful death exemption at § 522(d)(11)(B).
6 11 USC § 522(d)(5). Again, these amounts are often adjusted, so be sure to read the statute carefully.
7 See e.g., *In re Barner*, 239 B.R. 139 (Bankr. W.D.Ky. 1999).
8 28 USC §586(e).
9 11 USC §1325.
10 11 USC § 330(a)(1) and (a)(2).
11 11 USC § 326(a).
12 See 11 USC § 330(a)(3) and (a)(7) and *In re McKinney*, 383 B.R.490, 493 (Bankr.N.D.Cal.2008).
13 *In re Guido*, 237 B.R. 562 (Bankr.E.D.N.Y.1999);
In re Butts, 281 B.R. 176 (Bankr.W.D.N.Y.2002);
In re Coyote Ranch Contractors, LLC, 400 B.R. 84 (Bankr.N.D.Tex.2009)
In re B&B Autotransfusion Services, Inc., 443 B.R. 543, 545 (Bankr. D. Idaho 2011).
14 *In re Rowe*, 750 F.3d. 392 (4th Cir.2014)
In re Salgado-Nava, 473 B.R. 911, 919 (B.A.P. 9th Cir. 2012).
In re Scroggins, 517 B.R. 206 (Bankr. E.D. Cal. 2014).
15 *Reisz v. Crocker*, 2014 WL 7342686 (W.D.Ky.Dec. 23, 2014).
16 *In re Moore*, Case No. 11-20959, currently pending before the Eastern District of Kentucky Bankruptcy Court at the time of this writing. This case does involve litigation proceeds.