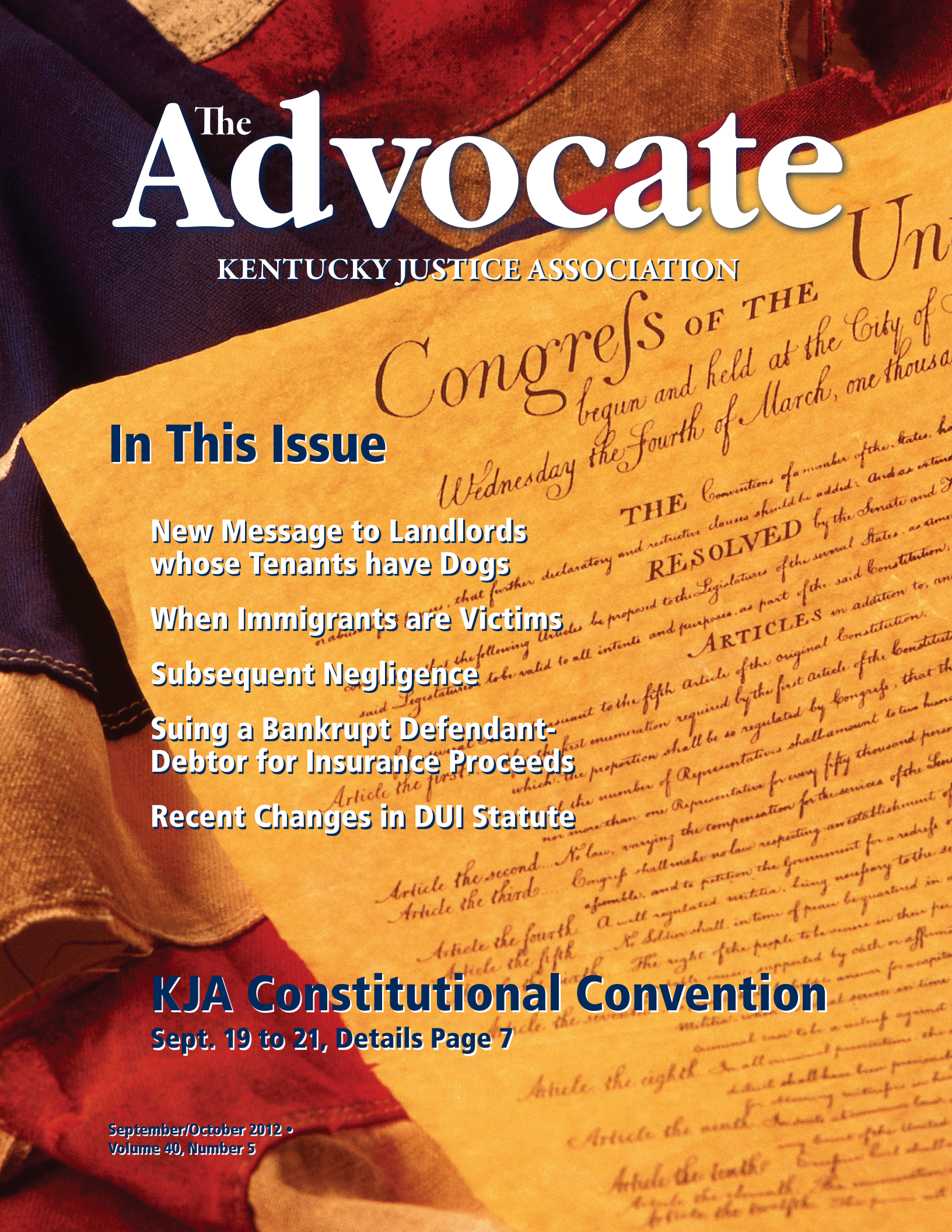

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By Justin Lawrence

Suing a Tortfeasor in Bankruptcy for Insurance Proceeds

Even the most seasoned litigator can stumble when a bankruptcy intrudes upon a civil action. A defendant-turned-debtor invokes powerful protections under federal bankruptcy law by filing a bankruptcy petition, and the unwary practitioner may lay claim to a stalled suit, a void judgment, or even monetary sanctions unless precise measures are taken to satisfy bankruptcy regulations. While procedures vary from court to court and predilections differ from judge to judge, the following is a blueprint for suing a bankrupt defendant-debtor for insurance proceeds while also keeping open the option of collecting any judgment in excess of the insurance policy from the bankruptcy estate.

Did Your Case's Facts Occur Pre- or Post-Filing?

When a defendant tells you he or she has filed a bankruptcy, ask for the case number. Your first step should be to access the bankruptcy court's website via PACER (www.pacer.gov) and look up the defendant's bankruptcy case. The filing date of the voluntary petition is of paramount importance. If the tortious action or breach occurred on or before the date the voluntary petition was filed, then your claim falls within the protection offered by the bankruptcy and you cannot proceed with your civil action without taking action through the bankruptcy court. However, if the tortious action or breach occurred after the date the voluntary petition was filed, then your claim falls outside the protection of the bankruptcy court and a civil action can proceed.

Pursuing a Civil Action While the Bankruptcy Action is Active (i.e., Pre-Discharge)

Of the various forms of bankruptcy, the three most commonly seen are Chapter 7, Chapter 13 and Chapter 11. Because each type of bankruptcy receives a discharge at different points along the bankruptcy timeline, you should carefully review the court's file for an Order of Discharge. For reference, a Chapter 7 is granted a discharge as soon as the period for filing objections has passed. A Chapter 13 is granted a discharge upon completion of their repayment plan—typically three to five years. A Chapter 11 is granted a discharge as soon as the plan is confirmed.

In any Chapter 13, 11 or any Chapter 7 with assets, it is imperative you file a Proof of Claim in the bankruptcy as a creditor, even if your client was never put on formal notice of the bankruptcy. The proof of claim should be for the full amount of foreseeable damages.[1] A proof of claim form is provided on the bankruptcy court's website. Although it is not necessary to file a proof of claim in order to pursue insurance proceeds,[2] the proof of claim is necessary should you receive a judgment in excess of insurance proceeds and seek to collect the excess judgment from the defendant-debtor.[3] If you do file a claim, you are asking the court to pay you any damages in excess of the policy as an unsecured creditor.[4] As an unsecured creditor, you get a low priority—essentially getting the dregs that are left over after secured creditors have been paid in full. However, in a bankruptcy where the debtor has assets or significant income, even unsecured creditors sometimes get paid in full.

In addition to filing a proof of claim, file a Motion for Relief from the automatic stay with the bankruptcy court. The automatic stay, in layman's terms, is the "do not touch" sign that the bankruptcy court hangs around the neck of every bankruptcy filer at the moment of filing. It applies to every form of creditor, and violating it carries severe penalties. However, relief from the automatic stay may be granted to a party in interest "for cause."[5] The bankruptcy court has the discretion to determine whether permitting a civil action to go forward constitutes cause, but case law suggests that permitting a collateral matter to proceed in another forum should constitute cause for granting relief from stay.[6] The bankruptcy court is tasked with balancing the prejudice to the bankruptcy debtor's estate with the hardship of the plaintiff-creditor should relief be denied. A three-part test exists to assist the court.[7] If relief is granted, it will permit

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your client's case to proceed in the appropriate court. Even if relief is not granted, some courts have suggested that the diligence shown by the creditor in asking for relief should be taken as a factor in the creditor's favor should the creditor need to re-open the bankruptcy post-discharge.[8]

If you need to file a case while the bankruptcy is still active, filing a proof of claim keeps the option of full damages on the table, while moving for relief from stay gives you the ability to pursue damages sooner rather than later.

Pursuing a Civil Action After the Bankruptcy Action is Over (i.e., Post-Discharge)

Sometimes you will not have the opportunity to intercede in the bankruptcy while it is still active. In such cases, the defendant-debtor will have received a discharge before you can file a proof of claim. The discharge injunction is very powerful. Filing a lawsuit with knowledge that the discharge injunction may affect your claim can violate the discharge injunction and lead to civil contempt sanctions against the plaintiff-creditor[9] and/or sanctions against the attorney under Federal Rule of Bankruptcy 9011.[10] However, reopening the bankruptcy case and receiving an order allowing a suit nominally naming the debtor can modify the discharge injunction.

There is a limit on your ability to pursue the debtor by modifying the discharge injunction without having filed a proof of claim—you will only be able to name the debtor nominally for pursuing insurance proceeds. The general rule is that Section 524 of the bankruptcy code only prohibits suits collecting from the debtor directly. It does not erase the debt related to the tortious act or breach, so the debt can be collected from another entity that may be liable on behalf of the debtor. Although some sources suggest a lack of clarity in the Sixth Circuit regarding a plaintiff-creditor's ability to name a discharged defendant-debtor nominally in pursuit of insurance proceeds, both the Eastern and Western Districts of Kentucky have affirmatively stated that this is permissible.[11]

If your client files to have the bankruptcy case re-opened and the discharge injunction modified, the defendant-debtor can object due to the delay and re-opening. However, the defendant-debtor must show actual prejudice due to the delay and case law

implies that there must be specific facts showing the plaintiff-creditor delayed after receiving actual knowledge of the bankruptcy.[12] A defendant-debtor may also argue that the lawsuit will imperil the fresh start afforded by the discharge, but merely attending depositions or trial is not such a burden that this defense will be successful.[13]

One last note on modifying the discharge injunction: many courts say it is completely unnecessary, although definitive authority on this subject does not exist in the Sixth Circuit at the appellate level. Courts in Tennessee have decided that moving to modify is unnecessary,[14] while the Western District of Kentucky, in dicta, has indicated that such a motion should be made.[15] Thus, it is the safer practice to make the motion, rather than to ask for forgiveness after the fact.

Oops… I Filed Suit Without Doing Any of This. What Now?

If you file suit against the defendant-debtor without getting permission from the bankruptcy court, you are on thin ice no matter which way you tread. However, being proactive can make this a minor speed bump rather than a fatal error. First, you need to acknowledge the bankruptcy with the trial court and the defendant by placing the case in abeyance so the bankruptcy court can be notified. Most cases where sanctions have been awarded against a plaintiff-creditor or counsel involve repeated actions in state or federal district court against a defendant-debtor in willful disregard of the bankruptcy. Pretending the bankruptcy isn't there won't make it go away.

An action filed or judgment received in violation of an automatic stay or discharge injunction is voidable.[16] A lawsuit filed in violation of the stay or discharge injunction does not toll the statute of limitations, and if not re-filed properly the plaintiff-creditor can lose his right to file the suit.[17] Pursuant to 11 USC §108(c), the plaintiff-creditor has until either: (1) the end of the applicable statute of limitations or (2) thirty days after the stay is terminated and converted into a section 524 injunction in which to file suit. 108(c) is the final authority on the time for filing lawsuits against a bankrupt defendant.

Make sure to check the schedules filed with the defendant-debtor's bankruptcy. If your client was not listed *and* did not have actual knowledge of the bankruptcy, then the discharge does not apply.[18] However, due to the severe penalties associated with violating the automatic stay or discharge injunction, you should only rely on this rule as a last resort.

Conclusion

Like most areas of practice, a defendant's bankruptcy can be handled with good communication skills and a proactive approach. Notify the applicable court(s) and parties, file a few simple documents, and you can protect your client's claim and some (if not all) of the associated damages, letting you focus on the heart of your case.

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1 See, e.g., *Hendrix v. Page* (In re of Hendrix), 986 F.2d 195, 199 (7th Cir. 1993).

2 *In re HNRC Dissolution Co.*, 2005 Bankr. LEXIS 1451, 54 Collier Bankr. Cas. 2d (MB) 1002 (Bankr. E.D. Ky. July 29, 2005).

3 *In re Fine Air Servs. Corp.,* 2005 Bankr. LEXIS 2849, 19 Fla. L. Weekly Fed. B 463 (Bankr. S.D. Fla. May 17, 2005); *In re Doar*, 234 B.R. 203, 204 (Bankr. N.D. Ga. 1999); *Green v. Welsh*, 956 F.2d 30, 33 (2d Cir. 1992).

4 *Id.*

5 11 U.S.C. § 362(d)(1).

6 *Ohio Valley Carpenters District Council, Local No. 415 v. Valley Kitchens, Inc. (In re Valley Kitchens, Inc.)*, 58 B.R. 6 (Bankr. S.D. Ohio 1985).

7 *Peterson v. Cundy (In re Peterson)*, 116 B.R. 247, 249 (Bankr. D. Colo. 1990). *Robbins v. Robbins (In re Robbins)*, 964 F.2d 342, 345 (4th Cir. 1992).

8 *In re Shondel*, 950 F.2d 1301, 1305 (7th Cir. 1991).

9 *Pertuso v. Ford Motor Credit Co.*, 233 F.3d 417, 421-23 (6th Cir. 2000).

10 *Jackson v. Law Firm of O'Hara, Ruberg, Osborne & Taylor*, 875 F.2d 1224 (6th Cir. 1989).

11 *In re Smith*, 334 B.R. 233, 235 (Bankr. W.D. Ky. 2005); *In re HNRC Dissolution Co.*, 2005 Bankr. LEXIS 1451, 54 Collier Bankr. Cas. 2d (MB) 1002 (Bankr. E.D. Ky. July 29, 2005). *See also In re Patterson* case, 297 B.R. 110 (Bankr. E.D. Tenn. 2003) and In re Harrison, 206 B.R. 910, 1997 Bankr. LEXIS 329 (Bankr. E.D. Tenn. 1997) (internal citations omitted) – "Some courts have suggested that the Sixth Circuit has reached a different result, citing the case of *Citibank v. White Motor Corporation (In re White Motor Credit)*, 761 F.2d 270 (6th Cir. 1985). Those courts have erroneously analyzed the *White Motor* case."

12 *In re Smith*, *supra*.

13 *In re Dorner*, 125 B.R. 198, 202 (Bankr. N.D. Ohio 1991); *Houston v. Edgeworth (In re Edgeworth)*, 993 F.2d 51, 54 (5th Cir. 1993).

14 *In re Patterson*, 297 B.R. 110, 115 (Bankr. E.D. Tenn. 2003); *In re Castle*, 289 B.R. 882, 888 (Bankr. E.D. Tenn. 2003).

15 *In re Smith*, *supra*, at 234.

16 *Easley v. Pettibone Mich. Corp.*, 990 F.2d 905, 910 (6th 1993).

17 *Id.*

18 11 USC §523(a)(3)(B).