

BANKRUPTCY

IT IS NOT THE END OF YOUR SUBROGATION CLAIM



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“I FILED BANKRUPTCY.”

**SHOULD YOU BE CONCERNED IF YOU HEAR THOSE
THREE WORDS FROM YOUR DEFENDANT/TARGET?**

YES...BUT YOU CAN FIGHT BACK.

The United States Bankruptcy Code is intended, at least in part, to give a debtor in bankruptcy relief from the demands of its creditors so that it can regroup and potentially survive those claims. It does this by shifting the playing field and changing some of the rules. But, the game is not necessarily over and there is no reason to forfeit.

Bankruptcy Stays Other Proceedings

When a debtor files a petition in bankruptcy, the protections of the Code begin immediately and automatically. The automatic stay, imposed by 11 U.S.C. § 362, protects the debtor's assets, provides temporary relief from creditors, and works to provide equity in the distribution of the debtor's assets to its creditors. In more concrete terms, the automatic stay immediately halts all actions against the debtor or against its property. In addition, the automatic stay applies equally to judicial and non-judicial efforts to recover damages from a debtor.

Typically, a defendant in litigation who files a bankruptcy petition will also file a Suggestion of Bankruptcy in the court of the pending litigation, though that Suggestion is not technically necessary and litigation is stayed automatically. While the automatic stay only applies to the bankruptcy debtor and not to co-defendants, the stay often functionally stays the entire case, even as to co-defendants.

Your Bankruptcy Claim

So, what should you do if you learn that your target has filed bankruptcy? First, you should protect your collection efforts by filing a proof of claim in the bankruptcy court.¹ The proof of claim, official form B10, places the bankruptcy court, the debtor, and other creditors on notice of your claim and puts you in a position to participate in the debtor's bankruptcy process. Your proof of claim will set forth the amount of your claim, the basis for your claim (negligence, product liability, etc.), and the date it arose, among other information. In addition, you will be required to attach documentation supporting or justifying your claim.

Even if you intend to do nothing else in the bankruptcy case, file your proof of claim. It is easy and can be accomplished in about the same amount of time as submitting a well-documented demand to a non-bankruptcy target. If you do not

file a proof of claim when required, you will not participate in the distribution, if any, to your class of creditors. So, again, file your proof of claim in every bankruptcy case.

When the Debtor has Liability Insurance

If your defendant has a policy of insurance that covers the damages you seek, then you may be able to avoid much of the impact of the bankruptcy filing. Liability insurance policies are typically not property of the debtor's bankruptcy estate because the debtor would have no right to keep those funds when an insurer pays a claim; however, pursuing the insurance proceeds still involves an action against the debtor. As a result, it is stayed by the function of the Code and it is still prudent to file a proof of claim. In addition, you should consider filing a motion for relief



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from the automatic stay that would allow you, if granted, to pursue your claim as if there were no bankruptcy filing. Oftentimes, in order to have a successful lift stay motion, you must be prepared to stipulate that you will seek recovery of damages exclusively from the insurance policy and will not pursue recovery from any assets of the estate. In determining whether to make such a stipulation, you must weigh policy limits against the size of your claim while keeping in mind the claim treatment and asset distribution issues discussed below. In short, however, you should be willing to make such a stipulation in all but the rare cases

where unsecured claims are likely to receive a distribution from the estate that will be greater than the likely recovery from the insurance proceeds.


The Claims Process

The filing of a proof of claim, whether an insurance policy is in force or not, begins the claims process, which can often move very slowly. The debtor will have the opportunity to object to claims for a multitude of reasons, specifically including a dispute as to liability or the amount of the claimed damages. If the debtor does not object to your claim, then it will be an allowed claim and will

be treated in accordance with the provisions of the Code.²

If the debtor does object to your claim on the basis of disputed liability or disputed damages, then that objection will likely be resolved by a trial of the issues to the bankruptcy court. It is important to note that in this scenario, you will not be entitled to a trial by jury. The filing of a proof of claim is an effective consent to the jurisdiction of the bankruptcy court and the claims process is a “core” matter. The bankruptcy court itself determines all core matters. Where the circumstances justify it, however, the bankruptcy court may lift the automatic stay and send the parties back to the non-bankruptcy court for





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claims within the class. The distribution amount is governed by the priorities set forth in the Code. In general terms, the money to be distributed to claimants flows down through the priority system and claimants holding claims below the level where the money runs out receive no distribution. The order of priority is: secured claims, administrative expenses of the bankruptcy estate, general unsecured claims, and other specified types of unsecured claims. Equity claims of the debtor are the lowest on this priority scale. For example, according to the Code, if money to be distributed by the bankruptcy estate is sufficient to pay the secured creditors, administrative claims, and five percent of the general unsecured claims, holders of general unsecured claims will receive five cents on the dollar for their claims.

While the example given above of a recovery of five cents on the dollar is only an example, it is unfortunately a very realistic one. Reorganization plans under Chapter 11 of the Bankruptcy Code commonly provide for little or no distribution to unsecured creditors. Liquidations under Chapter 7 of the Bankruptcy Code can be even less lucrative. However, there are also cases in which unsecured creditors are paid

in full. Distributions to holders of allowed claims cover the entire spectrum from zero to 100%, though most of those distributions are closer to zero than 100.

There are times when a creditor or group of creditors can shape the bankruptcy or the distributions in a case to a certain degree. Those activities are best left to bankruptcy specialists and are not covered here. Just remember that larger bankruptcies and larger claims in those bankruptcies may justify retention of bankruptcy counsel.

Conclusion

Bankruptcy is not the death knell for your claim, but it does dramatically change your claim. As noted above, I recommend that you file a proof of claim every time one of your targets files bankruptcy. It is easy and preserves all options.

Endnotes:

- 1 A creditor is not required to file a proof of claim in a Chapter 11 case if the debt is listed appropriately and accurately and is not listed as contingent, disputed, or unliquidated. There are also no-asset Chapter 7 cases in which the court requests that you not file a proof of claim until given notice to do so by the court. Rather than risk a misstep, however, I recommend filing a proof of claim in every case unless you have consulted with bankruptcy counsel.
- 2 Frequently, this is not the good news it appears to be. One of the more common reasons that would cause a debtor to enter no objections to a claim it previously disputed is that there will be no distribution to that class of creditors, making an objection unnecessary.

determination and rendition of judgment. The resulting judgment would then be the basis for an allowed claim in the bankruptcy court.

The next step in this process is the treatment of all allowed claims. The bankruptcy court will determine, through confirmation of a plan of reorganization or approval of a Chapter 7 trustee's proposed distribution of estate assets, how much each holder of an allowed claim receives on account of that claim. All claimants within a given class will receive the same treatment as all other