Bankruptcy Issues in Personal Injury and Insurance Cases

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I. INTRODUCTION

Bankruptcy issues arise more and more frequently today in personal injury litigation, subrogation litigation, and coverage and bad faith litigation. Most often, the initial response is that the case is stayed by virtue of the "super" stay imposed by section 362 of the United States Bankruptcy Code. Many factors, however, can affect the interests of the insurer and the insurer, despite the presence of bankruptcy. In fact, in certain situations, the insurance proceeds do not become property of the bankruptcy estate and, thus, are not subject to the automatic stay.

In 2005, President Bush signed into law the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("the Act"), which extensively revamped Title 11 of the United States Code, known as the Bankruptcy Code. In some respects, the changes made by the Act will impact litigation that involves insureds and insurers. In other respects, the law interpreting and applying the Bankruptcy Code will remain unchanged. By this paper, I will provide an introduction to the basics of bankruptcy, an overview of the changes triggered by the Act, and a discussion of bankruptcy issues that can arise in personal injury and insurance litigation.

II. BANKRUPTCY 101

First, our primer in bankruptcy law.[2] In general, the Bankruptcy Code provides for three main types of bankruptcies:

- Chapter 7 – individual or corporate liquidation bankruptcy
- Chapter 11 – corporate reorganization bankruptcy (also available for certain individuals who meet requirements)
- Chapter 13 – individual wage-earner reorganization bankruptcy

The Code also provides for debt adjustment for a municipality, family farmer, and family fisherman, but those provisions do not arise often in our context.

A. Filing the Bankruptcy Petition

When a person or entity files a bankruptcy petition, most, if not all, assets of the person or entity become property of the bankruptcy estate on that date and are subject to the control of the bankruptcy court. *See* 11 U.S.C. § 541. This includes any contingent or unliquidated interests, such as an unfiled lawsuit or a pending lawsuit that has not been reduced to judgment. *Id.* at § 541(a)(1). Also, on the date of filing, an automatic stay commences to protect the debtor from collection actions, lawsuits, foreclosure, or other action to collect a debt, enforce a contract, etc. *See* 11 U.S.C. § 362. With regard to state court lawsuits, the automatic stay divests the state court of jurisdiction over the debtor.

The debtor is held to a strict standard of disclosure and must disclose all known assets and liabilities (even if unliquidated or contingent) in documents filed shortly after the petition, such as a Statement of Financial Affairs and Schedules of Assets and Liabilities. *See* 11 U.S.C. § 521(a). In Chapter 7 cases and when needed in other cases, the Trustee conducts a meeting of creditors, known as the 341 meeting (after the Code section), in which the Trustee questions the debtor about the schedules and statements and allows creditors to question the debtor about assets and liabilities and other information relevant to the debtor's financial situation. *See* 11 U.S.C. § 341(a). The Trustee, creditors, and any party-in-interest may also seek to examine the debtor by requesting an examination under Bankruptcy Rule 2004 (similar to a deposition). FED. R. BANKR. P. 2004.

B. Types of Bankruptcy Filings

In a Chapter 7 bankruptcy, all the debtor's non-exempt property becomes property of the bankruptcy estate, and a Trustee is appointed to liquidate the non-exempt property and distribute the proceeds to the creditors. *See* 11 U.S.C. §§ 701-726. Once completed,

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[2] This paper is intended for general educational purposes only and should not be used as legal advice in any individual case. If you have specific questions about bankruptcy as applied to particular facts, you should consult with your attorney.

the debtor receives a discharge of personal liability on all debts included in the bankruptcy. *See* 11 U.S.C. §§ 524, 727.

In a Chapter 11 reorganization bankruptcy by an entity, the company usually continues to operate itself as a debtor-in-possession, as opposed to appointing a Trustee, which responsibility imposes numerous reporting and other requirements. *See* 11 U.S.C. § 1107. The debtor-in-possession usually promptly seeks a variety of post-petition orders from the bankruptcy court to allow it to continue paying utilities, trade creditors, and others necessary to keep the business running, and to obtain post-petition financing to operate the business. If the debtor-in-possession fails to successfully operate the business or fails to comply with certain Bankruptcy Code requirements (reporting, etc.), the creditors or the court can move for appointment of a Trustee to run the business. *See* 11 U.S.C. § 1104.

The goal for a debtor-in-possession in a Chapter 11 case is to disclose all relevant information to creditors about the state of the business and to propose a plan of reorganization that adjusts the debt and provides for future operation of the company. *See* 11 U.S.C. §§ 1121-29. If the Chapter 11 plan is completed (and no exception applies), the debtor receives a discharge. *See* 11 U.S.C. § 1141.

In a Chapter 13 individual reorganization, the goal is to adjust certain debts (primarily unsecured) and design a repayment plan that pays creditors a certain amount per month. *See* 11 U.S.C. §§ 1321-29. Essentially, the debtor determines what is his disposable income (the amount remaining after deducting certain qualifying expenses from income) and pays that amount to a Chapter 13 Trustee, who then disburses it in monthly payments to creditors (often only a few cents on the dollar). The term of the Chapter 13 Plan can be up to 60 months and, if the debtor completes all the payments, he receives a discharge. *See* 11 U.S.C. § 1328.

C. Other Bankruptcy Issues

Individual debtors can exempt certain property, such as a homestead, under the federal bankruptcy code provisions (11 U.S.C. 522) or under state property law, whichever provides more favorable exemptions under the debtor's particular circumstances. Secured creditors, in general, are allowed to maintain their liens but may lose unsecured deficiency claims. The goal of most individual bankruptcies is to allow the debtor to keep the homestead by becoming current on any past amounts due and owing and continuing to make monthly payments post-petition.

The Bankruptcy Code contains several provisions that work to prevent debtors from favoring one creditor over others by making lump-sum payments or transfers of property in the months preceding bankruptcy (known as preferences or fraudulent transfers). If a creditor receives a preferential payment or transfer within a specified time period (usually 90 days), the Trustee or debtor-in-possession is authorized to sue to recover those payments to bring them back into the bankruptcy estate for distribution to creditors.

III. THE NEW BANKRUPTCY ABUSE PREVENTION AND CONSUMER PROTECTION ACT OF 2005

Now, to the most recent changes to the Bankruptcy Code. On April 20, 2005, the President signed the Act, which was designed to prevent abuses of the bankruptcy system and to protect consumers. Most provisions of the Act took effect on October 17, 2005. The Act has been widely criticized in part for its substance and in part for the role politics played in getting the legislation passed.

Some of the most ardent critics are the bankruptcy courts themselves. Many critics say the Act should have been named the Bankruptcy Abuse Prevention and *Creditor* Protection Act because it significantly increased the burdens on consumers seeking bankruptcy and the attorneys representing consumer debtors, mostly at the behest of powerful lobby groups such as credit card companies. Critics say the new Act makes it difficult, if not impossible, for low-income working families, single mothers, minorities, and the elderly to seek bankruptcy protection when they have a legitimate reason for filing, such as losing a job or facing a medical emergency.

The Act shifts the focus from protecting the individual debtor and sending him out with a "fresh start" (the goal of earlier versions of the Bankruptcy Code) to presuming the individual debtor is abusing the bankruptcy system. For individuals with a certain amount of income, the Act presumes abuse of the system, forcing the debtor to rebut that presumption of abuse by explaining why he really needs to file bankruptcy. One goal of the Act is to corral more individuals into Chapter 13 reorganizations instead of Chapter 7 liquidations so that more unsecured creditors (*e.g.*, credit card companies) get paid.

To avoid the new, stringent requirements, hundreds of thousands of people filed Chapter 7 bankruptcies in the period just prior to October 17, 2005, the effective date of the Act. The Chapter 7 filings were up 50% over the same period in 2004, while Chapter 13 filings declined slightly. Total bankruptcy filings rose 30% in 2005 over the previous year. Since the Act took effect, however, overall bankruptcy filings (particularly Chapter 7) have fallen significantly and corporate bankruptcy filings are at the lowest level since 1997.

A. Changes to Bankruptcy Filing and Discharge Requirements

The Act makes filing for bankruptcy much more onerous for the individual consumer filer, as well as his attorney. For example, an attorney who counsels consumer clients about bankruptcy for a fee may be considered a "debt relief agency" and must disclose this fact in any advertising. As a "debt relief agency," the attorney is subject to numerous new reporting and disclosure requirements.

Also, in a Chapter 7 case, the attorney must conduct a reasonable investigation into the information contained in a debtor's petition, schedules, and statements because the attorney now has to certify to the accuracy of the information contained in the documents. The ethical standards of federal rule 11, made applicable to bankruptcy cases by bankruptcy rule 9011, apply to such filings, and sanctions can be imposed for noncompliance.

Here is a sampling of some of the more onerous requirements that have been added by the Act:

1. The debtor must attend consumer credit counseling from an approved agency within 180 days of filing for bankruptcy, and the debtor must attach a certificate of completion to his bankruptcy petition. If he fails to do so, the case can be dismissed.

2. To file a Chapter 7 petition, the debtor must satisfy the "means test" contained in section 707(b). This section is extremely complicated but, in essence, seeks to determine whether the debtor has the financial capacity to pay some money to the creditors, in which case the debtor must file a Chapter 13 reorganization instead of a Chapter 7 liquidation. The "means test" involves comparing a calculation of the potential debtor's income to the median income of the state whether the debtor plans to file. If a debtor's income is above the median, then whether he can file a Chapter 7 or must file a Chapter 13 is determined through more complicated calculations involving debt to excess income ratios. The term of the Chapter 13 Plan also is affected by whether the debtor's current monthly income is above or below the median income for his state. The median income by state can be found at www.census.org.[3]

3. The debtor must file many additional documents (in addition to petition, schedules, and statements), such as certificate of credit counseling, payment advises (proof of employment for last 60 days prior to bankruptcy), tax returns, photo ID, and statement of monthly net income and any anticipated increase in income or expenses after filing, among others.

4. The Chapter 7 and Chapter 13 debtor may not receive a discharge until they provide proof they completed an education course in personal financial management approved by the U.S. Trustee.

5. The individual debtor in a Chapter 7 must provide a statement of intention with regard to secured property (such as automobiles) within 30 days of the 341 meeting of creditors. The statement of intention means a statement as to whether the debtor is going to surrender or retain the property. If the property at issue is personal property secured by a purchase money security interest (such as an automobile, furniture, jewelry, computers, and the like), and if the debtor fails to either redeem the property (pay the fair market value of the secured claim, 11 U.S.C. § 722), or reaffirm the debt (sign a new agreement to pay the old debt, which would otherwise be discharged, 11 U.S.C. § 524) within 45 days from the 341 meeting, the automatic stay is automatically terminated without any need for a motion by the creditor. The creditor then can exercise whatever remedies it has under non-bankruptcy law, subject only to a request by the Trustee to extend the period upon payment of "adequate protection" payments to the creditor.

B. Consumer Protection Additions

The Act does contain some positive additions. Congress has given favorable treatment to "domestic support obligations," which is a broad label now applied

[3] The median income for Texas for 2002-2004 was $41,275 (with a $458 margin of error), placing it in the bottom third of U.S. states. Of the fifty states, New Hampshire had the highest median income at $57,352, and West Virginia had the lowest median income at $32,589. *See* http://www.census.gov/hhes/www/income/income04.html.

to child support, alimony, maintenance, and other family law obligations arising from divorce decrees, separation agreements, property settlement agreements, and court orders. *See* 11 U.S.C. § 101(14A). Domestic support obligations have been elevated to priority claim status, meaning they are paid well ahead of unsecured claims and even some administrative and tax claims. *See* 11 U.S.C. § 507(a)(1). Also, domestic support obligations generally are not dischargeable in bankruptcy. 11 U.S.C. § 523(a)(5). A Chapter 13 debtor cannot get his plan confirmed unless he is current on all pre-petition and post-petition domestic support obligations. 11 U.S.C. § 1325(a)(8).

The Act also exempts most types of retirement plans and education savings plans, without regard to whether the debtor chooses federal or state exemptions. *See* 11 U.S.C. § 522. Further, payments or contributions to retirement plans are not treated as disposable income.

In addition, the Act addresses a particular group of bankruptcy abusers – the serial bankruptcy filers. Congress has carved out exceptions to the automatic stay applicable to serial bankruptcy filers. If the individual had a pending case, within one year preceding the current case, that was dismissed for any reason other than failure to qualify under the "means test" under section 707(b), the individual will only receive the benefit of the automatic stay for 30 days after filing. The debtor must prove his entitlement to an extension of the automatic stay beyond 30 days as to one or more creditors.

If the individual had two pending cases, within one year preceding the current case, that were dismissed for any reason other than failure to satisfy section 707(b), the individual will receive no automatic stay after filing. The debtor must prove, within 30 days of filing, his entitlement to application of the automatic stay as to one or more creditors.

Also, the Act sought to remedy the abuse by certain individuals who ran up their credit card bills with vacations, boats, expensive cars, or other luxury items, and then filed bankruptcy to avoid paying the debt. The Act provides that debts for luxury goods are not dischargeable if over $500 and made within 60 days of the bankruptcy filing. The same is true of cash advances exceeding $750 and made within 70 days of filing. *See* 11 U.S.C. § 523.

The Act also adds protections for consumers interested in signing reaffirmation agreements, which are essentially agreements to reaffirm an old debt (such as a car loan) that would be discharged in the bankruptcy. The documents now must contain numerous disclosures and explanatory provisions, and the debtor's attorney must perform an analysis of whether payment under the reaffirmation agreement will impose an "undue hardship" on the debtor. *See* 11 U.S.C. § 524. Also, the debtor's attorney must sign and certify the reaffirmation agreement is not an undue hardship. *Id.*

C. <u>Protections for Creditors</u>

Creditors also obtained some new protections by virtue of the Act. The Act maintains the Trustee's power to file preference and fraudulent transfer actions against creditors of the debtor if they got favorable lump-sum payments in the 90 days (or 1 year for insiders) preceding bankruptcy. However, Congress added a new minimum amount for such actions. *See* 11 U.S.C. § 547. In a consumer case, the Trustee cannot seek to avoid a preferential transfer if it is less than $600. In a non-consumer case, the Trustee cannot seek to avoid a preferential transfer if it is less than $5,000.00. This conserves estate assets by reducing preference litigation, and it shields many routine monthly payments made by consumers and business owners. Also, the Act has eased some of the defenses to preference actions that can be asserted by creditors.

With respect to conversion or dismissal, the Act imposes a new laundry list of bases for a creditor to move or for the court to order a reorganization case converted to a liquidation or to dismiss the case. *See* 11 U.S.C. §§ 707, 1112, 1307. In addition to the prior Code's grounds that included fraud, dishonesty, delay, failure to timely propose a plan, or "cause," the Act adds failure to comply with reporting requirements, failure to attend a 341 meeting or rule 2004 examination of the debtor (like a deposition), failure to comply with a court order, failure to cooperate with an audit, failure to timely pay taxes or file tax returns, and failure to timely pay any domestic support obligation that first becomes payable post-petition. The Act also imposes time limits for hearing on a motion to convert or dismiss and time limits for the bankruptcy court to rule on such motions.

Chapter 13 cases no longer have the "super-discharge" they used to have. *See* 11 U.S.C. § 523, 1328. The Act adds a number of exceptions to discharge for Chapter 13 debtors, including liability for unfiled taxes, liability for fraudulent tax returns, claims for fraud or false pretenses, liability for unscheduled debts, and several others. Also, claims for restitution or damages awarded in a civil action as a result of willful or malicious injury by the debtor that caused injury to or death of an individual are not dischargeable.

Overall, critics say the main impact of the Act on consumers will be to make bankruptcy relief considerably more expensive and considerably less effective (*i.e.*, less of a "fresh start"). Many naysayers have predicted the death of Chapter 7 bankruptcies.

The Act's onerous filing provisions will also make bankruptcy totally inaccessible for some consumers. Critics also say the "means test" can be manipulated by higher income consumers, and that the new exemptions for retirement plans and education savings accounts will protect primarily higher income consumers. The real effects, of course, remain to be seen, as the new Act has only been in effect for six months.

IV. BANKRUPTCY ISSUES IN PERSONAL INJURY AND INSURANCE CASES

When an insured who is party to a personal injury lawsuit files bankruptcy, issues can arise in a variety of contexts affecting the litigation. These include the applicability of the automatic stay, the extent of the debtor's disclosures in bankruptcy, whether the insurance policy and its proceeds are property of the bankruptcy estate, whether a *Stowers* claim arises, and the effect of the debtor's discharge on rights under the insurance policy.

A. Effect of Bankruptcy on Litigation Deadlines

In most cases, when an insured (who is also a defendant in a lawsuit) files for bankruptcy, section 362 of the Bankruptcy Code takes effect to automatically stay (i) the commencement or continuation of a judicial, administrative, or other action against the debtor that was or could have been commenced pre-petition or any action to recover a claim against the debtor that arose pre-petition, (ii) action to enforce a pre-petition judgment against the debtor or property of the estate; (iii) action to obtain possession of estate property; (iv) action to create, perfect, or enforce any lien against property of the estate, (v) any act to collect on a pre-petition claim or debt, and other specific actions. *See* 11 U.S.C. § 362(a). The automatic stay deprives a state court of jurisdiction over the debtor. *Padrino Maritime, Inc. v. Rizo*, 130 S.W.3d 243, 246 (Tex. App.–Corpus Christi 2004, no pet.). And, any action taken in violation of the automatic stay is void, not merely voidable. *Continental Casing Corp. v. Samedan Oil Corp.*, 751 S.W.2d 499, 501 (Tex. 1988).

Actions against the debtor, as broadly defined in section 362(a), includes a personal injury lawsuit against the insured/debtor. The automatic stay extends to affirmative actions against the debtor in the lawsuit, and it includes such activities as sending discovery, filing dispositive motions, proceeding with trial, and seeking to enforce any judgment. If a lawsuit has multiple defendants, some courts will sever the bankrupt defendant to allow the remaining case to proceed. Note that, if the debtor is the plaintiff or the moving party, the stay does not prohibit the plaintiff/debtor from commencing or prosecuting a suit or taking affirmative action, assuming the Trustee has authorized it[4] or the Trustee has abandoned the lawsuit back to the plaintiff/debtor.[5]

In *Padrino Maritime v. Rizo*, the plaintiff took a default judgment against an insured who had filed bankruptcy. The insured had filed a notice of bankruptcy in the state court suit, which he argued was the equivalent of an answer that precluded a default judgment. *Rizo*, 130 S.W.3d at 247. The court of appeals disagreed; it said any action taken while the automatic stay was in effect was void and without legal effect – including the original filing of the lawsuit (and any attempt to answer). *Id.*

Later in the same lawsuit, the plaintiff received relief from the automatic stay to pursue the lawsuit to judgment, and the plaintiff reissued and re-served the petition and citation. *Id.* The insured/debtor never filed an answer after the stay had been lifted, so the appellate court held the default judgment was proper. *Id.*

On another note, the *Rizo* court found that the insured/debtor's insurance carrier, insurance agent, and bankruptcy attorney acted with conscious indifference in failing to answer after the stay had been lifted, thus negating any chance at setting aside the default judgment. *Id.* at 248. The plaintiff's attorney had sent a copy of the motion for default judgment to the insured's bankruptcy attorney and had notified the insured's insurance agent that a default judgment was imminent.

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[4] In which case the Trustee is usually substituted as the plaintiff.

[5] In which case the debtor can sue as if the bankruptcy never existed.

Id. The broker notified the carrier that no answer had been filed and that a default judgment was pending. *Id.* For five months, none of these parties took any action toward answering for the insured. Thus, the court found the failure to answer was not the result of accident or mistake and upheld the default judgment. *Id.*

The lesson here, for insurers, is to make sure that your insured's interests are protected *after* the plaintiff has obtained relief from the automatic stay to allow the state court suit to proceed. Many times, the bankruptcy court will lift the stay to allow the lawsuit to proceed to judgment when the insured is being defended pursuant to a liability insurance policy – under these circumstances, the estate does not lose any money to payment of the insured/debtor's attorneys' fees. Once the plaintiff's claim is reduced to a judgment against the insured/debtor, some courts require the plaintiff to return to the bankruptcy court to obtain further approval and relief from the automatic stay to enforce the judgment against the debtor's insurance policy and obtain the policy proceeds.

B. Are the Policy and its Proceeds Property of the Bankruptcy Estate?

One common issue is whether the insured/debtor's insurance policy, as well as its proceeds, are considered assets of the bankruptcy estate that should be administered to creditors. The Fifth Circuit and federal bankruptcy courts have established a reasonably bright-line test for answering this question. It is undisputed that the insurance policy is property of the estate, but the question of whether the proceeds are property of the estate must be analyzed under the facts of each case.

First, the issue is whether the policy proceeds are payable directly to the insured as a beneficiary or whether the benefits are paid to a third party. If the benefits are payable directly to the insured, such as with a collision, life, or fire insurance policy (first-party coverages), they are property of the bankruptcy estate and will generally inure to the benefit of creditors. *In re Edgeworth*, 993 F.2d 51, 56 (5th Cir. 1993); *see also In re Asay*, 184 B.R. 265, 266 (Bankr. N.D. Tex. 1995) (proceeds from fire policy were property of the estate). But, if the proceeds are payable to a third party, such as under a typical liability policy, the insured/debtor will not have a cognizable interest in the proceeds, and they will not become property of the bankruptcy estate. *Edgeworth*, 993 F.2d at 56. Proceeds from a liability policy are payable to those harmed by debtor under the terms of the insurance contract. *Id.*

Second, the issue is whether the insured faces third-party claims within the limits of the policy coverage or whether the insured is involved in a mass tort situation with numerous claims on a limited pool of funds. *See In re Sfuzzi*, 191 B.R. 664, 666-67 (Bankr. N.D. Tex. 1996) (discussing *Edgeworth*, 993 F.2d at 56 n.21). In a mass tort case, bankruptcy courts have found that the insurance policy proceeds should be property of the estate, motivated by a concern that the court "would not otherwise be able to prevent a free-for-all against the insurer outside the bankruptcy proceeding." *Id.* at 666 (quoting *Edgeworth*, 993 F.2d at 56 n.21). Another concern in the mass tort case is that, if the insurance proceeds are not marshalled by the bankruptcy court, they may not cover the numerous claims and may expose the debtor's estate to liability. *Id.* at 666-67 (quoting *Edgeworth*, 993 F.2d at 56 n.21). Thus, if the insured faces only one or two claims under a liability insurance policy, the bankruptcy court likely will find the liability policy proceeds are not property of the estate and can be paid directly to the third party claimant. *Id.* at 668.

Life insurance policies attain their status as property of the bankruptcy estate depending on whether they are mature at the time of the bankruptcy filing. A life insurance contract that is unmatured at the time of filing is not property of the estate. *See* 11 U.S.C. § 522(d)(7). However, a debtor's interest in property acquired as a beneficiary of a life insurance policy within 180 days after the petition date is property of the estate.[6] 11 U.S.C. § 541(a)(5)(C). But, even though the insurance proceeds go into the bankruptcy estate, the Bankruptcy Code exempts a portion of the debtor's right to receive payment under a life insurance policy (assuming it insured the life of an individual of whom the debtor was a dependent on the date of the individual's death), "to the extent reasonably necessary for support of the debtor and any dependent of the debtor." 11 U.S.C. § 522(d)(11)(C); *see also Cyrak v. Poynor*, 80 B.R. 75, 79-81 (N.D. Tex. 1987). Under this framework, Congress intended that life insurance contracts with present monetary value be included in the estate and exempted partially to support the debtor, but intended to exclude

[6] If the property is acquired more than 180 days after the bankruptcy filing, it is not property of the bankruptcy estate, and the debtor may use it as he sees fit, without regard to creditors. *In re Hargis*, 887 F.2d 77, 79 (5th Cir. 1989).

unmatured life insurance contracts with only inchoate value because they offer little or nothing to the debtor's ability to pay creditors. *Cyrak*, 80 B.R. at 81.

C. Importance of Debtor's Full Disclosure of Assets in Bankruptcy Documents

The Bankruptcy Code imposes upon debtors an express, affirmative duty to disclose all assets, including contingent and unliquidated claims. 11 U.S.C. § 521(a). The duty of disclosure in a bankruptcy proceeding is a continuing one, and a debtor is required to disclose all potential causes of action. *E.g., Youngblood Group v. Lufkin Fed. Sav. & Loan Ass'n*, 932 F. Supp. 859, 867 (E.D. Tex.1996). "The debtor need not know all the facts or even the legal basis for the cause of action; rather, if the debtor has enough information ... prior to confirmation to suggest that it may have a possible cause of action, then that is a 'known' cause of action such that it must be disclosed." *Id.*

A potential personal injury claim or lawsuit that arises or is filed prior to the filing of the bankruptcy petition is property of the bankruptcy estate. *See* 11 U.S.C. § 541(a) (property of the estate includes "all legal or equitable interests of the debtor in property as of the commencement of the case"); *see also Stewart v. Hardie*, 978 S.W.2d 203, 208 (Tex. App.–Fort Worth 1998, pet. denied). Thus, the debtor has a duty to report the potential claim or suit – even if not yet filed, if contingent, or if unliquidated – on his bankruptcy schedules and statement of financial affairs. *Stewart*, 978 S.W.2d at 208.

If a bankruptcy debtor fails to disclose a potential claim or lawsuit on his schedules and statement of financial affairs, he may be judicially estopped from recovering on that claim in the state court tribunal. The doctrine of judicial estoppel applies when a party makes a sworn statement in a previous judicial proceeding that is inconsistent with the party's current position and the statement was deliberate, clear, and unequivocal. *See Miller v. Gann*, 842 S.W.3d 641, 641 (Tex. 1992) (per curiam); *American Sav. & Loan Ass'n v. Musick*, 531 S.W.2d 581, 589 (Tex. 1975). Judicial estoppel is designed to protect the integrity of the judicial system by preventing a party from "playing fast and loose" with the courts to suit the party's own purposes. *E.g., Ergo Science, Inc. v. Martin*, 73 F.3d 595, 598 (5th Cir.1996); *Zipp Indus., Inc. v. Ranger Ins. Co.*, 39 S.W.3d 658, 665 (Tex. App.–Amarillo 2001, no pet.).

When applying the doctrine of judicial estoppel against bankruptcy debtors, Texas courts have adopted a slightly different test employed by the Fifth Circuit to ensure consistency in application of federal bankruptcy law. Under this test, a party is judicially estopped:

(1) if its position is clearly inconsistent with the position taken in a previous case;
(2) the court accepted the previous position; and
(3) the non-disclosure was not inadvertent.

E.g., In re Superior Crewboats, 374 F.3d 330, 335 (5th Cir. 2004).

Under the first prong of this test, a debtor fails to disclose a potential or existing claim or suit if he states in his schedules and statement of financial affairs that he has no contingent or unliquidated claims, and no potential or existing lawsuits. Answering "no" or "none" in the sworn bankruptcy filings is "is tantamount to a representation that no such claim existed." *Id.*; *see also In re Coastal Plains, Inc.*, 179 F.3d 197, 210 (5th Cir. 1999).

The second prong is satisfied if the bankruptcy court relies on this non-disclosure in some manner (*e.g.*, granting a discharge, confirming a plan). *See Crewboats*, 374 F.3d at 335; *Coastal Plains*, 179 F.3d at 206 (need not be a formal judgment; court may adopt party's position as a preliminary matter or as part of final disposition).

The third prong – inadvertence – is met only when the debtor lacks knowledge of the undisclosed claim or has no motive for its concealment. *See Crewboats*, 374 F.3d at 335; *Coastal Plains*, 179 F.3d at 210. The party cannot blame his attorney for the failure to disclose. At least one court has effectively charged the plaintiff with notice of the potential claim at the time of its accrual. *See Stewart*, 978 S.W.2d at 208. In most instances, a debtor has a motive to conceal a potential claim that could bring assets into the estate, because the debtor can reap the benefits of a personal injury award without having to share it with his creditors. *See Crewboats*, 374 F.3d at 336.

If the defendant can prove these three elements based on a plaintiff/debtor's failure to disclose the claim or lawsuit in bankruptcy, the defendant may be able to obtain judgment (even summary judgment) that the claim is barred on principles of judicial estoppel. In *Stewart v. Hardie*, the appellate court affirmed a trial court's ruling that a husband's wrongful death claim was barred by judicial estoppel because he failed to list it on his bankruptcy schedules. The plaintiff husband's wife died on March 28, 1991, which is when his wrongful death claim accrued. *Stewart*, 978 S.W.2d at 208. The husband filed for bankruptcy on May 3, 1991, so he had a duty to list the potential wrongful death claim or lawsuit as an asset of his bankruptcy estate. *Id.* The court treated his omission of this asset from his bankruptcy documents "as a de facto denial that a wrongful death claim existed." *Id.*

Also, the husband did not file the wrongful death suit until two months after he received his discharge in bankruptcy, so the bankruptcy court had relied on the husband's omission in granting the discharge. *See id.* The *Stewart* court found this tactic showed the husband was acting deliberately and "'playing fast and loose'" with the courts by the timing of his filings. Therefore, because the federal law test was satisfied, the husband was judicially estopped from prosecuting the wrongful death action he failed to disclose in his bankruptcy case. *Id.*; *see also Zipp*, 39 S.W.3d at 665 (party who actively moved to deny creditor's claim in bankruptcy case could not sue creditor for same funds in state court); *but see In re Loveless*, 64 S.W.3d 564, 578-80 (Tex. App.–Texarkana 2001, no pet.) (finding no judicial estoppel in non-bankruptcy setting because party's alleged inconsistent statement was not clear, deliberate, and intentional).

Although some federal circuit courts do not adopt the principle of judicial estoppel, the Fifth Circuit takes seriously the debtor's mandatory duty to disclose its assets under section 521 of the Bankruptcy Code. The court has issued several opinions stripping bankruptcy debtors of their claims for failure to satisfy their mandatory disclosure obligations. State courts have also (although less frequently) applied the principle to dispose of a plaintiff's suit. If you learn that a plaintiff suing one of your insureds has filed for bankruptcy, you should review the bankruptcy schedules and statements to determine whether the suit was listed as an asset of the estate. If not, you may be able to seek relief on grounds of judicial estoppel, in addition to any other defenses.

D. Bankruptcy and *Stowers*

The Fifth Circuit addressed the availability of a *Stowers* claim in the presence of a bankruptcy proceeding in *In re Davis*, 253 F.3d 807 (5th Cir. 2001). In *Davis*, injured parties sued the insured for damages arising out of an automobile accident. The insured had liability insurance of roughly $20,000 per person and $40,000 per accident. *Id.* at 808. The insurer provided a defense to the insured, and the insured's counsel received a settlement demand from the plaintiffs but did not respond. *Id.*

Roughly six months later, the insurer intervened in the state court suit and paid the policy proceeds into the registry of the court. *Id.* The plaintiff counterclaimed against the insurer for an alleged *Stowers* violation.

On the day of trial, the defendant insured filed for bankruptcy. Approximately four months later, the bankruptcy court granted the defendant insured a Chapter 7 discharge. The plaintiffs filed a proof of claim in the bankruptcy case for $2.3 million.

Eventually the plaintiffs got the automatic stay lifted and the case proceeded to trial not once (first trial, defense verdict) but twice (second trial, plaintiff verdict for $550,000). *Id.* at 809. In between the two trials, the insurer filed an adversary proceeding in the bankruptcy seeking a declaration that no *Stowers* claim existed or would exist against the insurer arising out of the state court suit. *Id.* The bankruptcy court held the plaintiffs had a *Stowers* claim but it was owned by the bankruptcy estate. *Id.* The district court affirmed.

The Fifth Circuit reversed, finding no *Stowers* claim existed in the bankruptcy estate. The court reasoned that a *Stowers* claim does not accrue until the judgment in the underlying case becomes final. *Id.* (citing *Street v. Second Court of Appeals*, 756 S.W.2d 299, 301 (Tex. 1988)). Because the plaintiffs did not obtain a judgment against the insured until three years after he filed for bankruptcy, no *Stowers* claim accrued before then. *Id.* at 809-10. Accordingly, the insured had no *Stowers* claim on the date he commenced bankruptcy, so a *Stowers* claim could not be included in property of the estate. *Id.* at 810.

In addition, the debtor's discharge in bankruptcy more than two years prior to the judgment against him negated the existence of a *Stowers* claim. The *Stowers* claim requires *both* negligent failure to settle *and* harm or legal injury to the insured (typically, a judgment in excess of policy limits). *Id.* Even assuming the insurer's negligent failure to settle, the insured suffered no harm or legal injury because the bankruptcy discharge eliminated the insured's personal liability to the plaintiffs for any judgment in excess of the amount covered by the insurance policy. *Id.* (citing 11 U.S.C. § 524). Therefore, absent exposure to excess liability, the insured had no *Stowers* claim against the carrier. *Id.*

E. Effect of Debtor's Discharge on Insurer's Liability Under Insurance Policy

The answer to this question is simple: none. In *In re Edgeworth*, the Fifth Circuit considered whether a legal malpractice claim against a defendant/insured was extinguished when the defendant/insured received a bankruptcy discharge. *Edgeworth*, 993 F.2d at 53. More specifically, the plaintiffs wanted to pursue their lawsuit against the debtor in his name so they could establish his liability for purposes of recovering under his liability insurance policy. *Id.*

Under section 524 of the Bankruptcy Code, a discharge operates as an injunction against any attempt to sue or collect on a judgment or debt as a personal liabiity of the debtor. *Id.* The discharge in bankruptcy does not extinguish the debt itself, but only the debtor's personal liability for the debt. *Id.* In fact, section 524(e) expressly states that the debt still exists and can be collected from any other entity that might be liable. *Id.*

Examining the language of section 524(a), the Fifth Circuit held that a bankruptcy discharge of the insured does not affect the liability of liability insurers and does not prevent a party from establishing their liability by proceeding against a discharged debtor. *Id.* at 54. The court said, "[I]t makes no sense to allow an insurer to escape coverage for injuries caused by its insured merely because the insured receives a bankruptcy discharge. 'The "fresh start" policy is not intended to provide a method by which an insurer can escape its obligations based simply on the financial misfortunes of the insured.'" *Id.* (citation omitted). Such a result would be "'fundamentally wrong.'" *Id.* (citation omitted).

The *Edgeworth* court also held that allowing litigation against the named insured to establish liability under the insurance policy did not inequitably burden the debtor. *Id.* Although the debtor may lose time by attending a deposition or trial, the debtor was not having to pay for his own defense. *Id.*[7] Therefore, as long as the costs of defense are borne by the insurer and the plaintiff does not execute on a judgment against the debtor personally, the bankruptcy discharge provisions will not bar a suit against the discharged defendant as the nominal defendant (defendant in name only). *Id.* The court also noted that, even though the plaintiffs did not file a proof of claim in the defendant/insured's bankruptcy, this did not impair their rights to sue another party who may be liable on the debt. *Id.* at 55; *see also In re Coho Res., Inc.*, 345 F.3d 338, 343 (5th Cir. 2003).

[7] The court noted that "such threats to Edgeworth's pocketbook" (*i.e.*, having to incur legal expenses) might require a different result. *Id.* at 54. However, the court cited to a Tenth Circuit opinion in which the court held the debtor could be sued post-discharge even if he would incur legal expenses. *Id.* at n.9.