



Stressed About Distress: What Happens When One of the Parties to Your Lawsuit Is in Danger of Filing, or Actually Does File, Bankruptcy?

# Common Issues That Arise When a Party to Litigation is in Financial Distress

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When signs of financial distress of a party to litigation emerge, familiarity with certain issues that arise in bankruptcy litigation can help you to better protect your client's economic interest. At the presentation on this topic at the 2014 ABA Section of Litigation Annual Conference in Scottsdale, Arizona, the panel will discuss certain common scenarios involving parties to litigation who are in financial distress and provide insight into how a litigator can properly plan for those fact patterns. The purpose of this paper is not to address all of those scenarios; rather, it is to present some of the bankruptcy litigation topics that arise most frequently, including: (i) how a bankruptcy filing may affect a settlement; (ii) substantive laws and procedural rules that apply upon the commencement of a bankruptcy filing; and (iii) Director and Officer ("D&O") issues that are common to many corporate bankruptcy filings.

## **I. Bankruptcy filing impact on a settlement**

How does a future bankruptcy filing affect the rights and obligations of the various parties to a settlement agreement? Several issues arise when a settlement party files for bankruptcy. For instance, settlement proceeds may be considered property of the estate and therefore payments made pursuant to a settlement may be avoided by a bankruptcy trustee. For example, the recipient of settlement proceeds may be subject to preference litigation. Pursuant to 11 U.S.C. § 547, certain payments made by a debtor in advance of the commencement of a bankruptcy filing may be avoided and recovered by a bankruptcy trustee. In order to avoid such payments, the trustee must demonstrate that the payments (1) were of the debtor's property; (2) were made to or for the benefit of a creditor; (3)

were made for or on account of an antecedent debt; (4) were made while the debtor was insolvent; (5) were made within 90 days before the bankruptcy was filed (or one year in the case of an “insider”); and (6) allowed the creditor to receive more than the creditor would receive in the bankruptcy had it not received the payments.<sup>1</sup> In order to protect a payment made pursuant to a settlement agreement from later being avoided as a preference if the defendant subsequently files for bankruptcy, any plaintiff’s counsel with a concern about financial condition of the debtor should consult bankruptcy counsel about how to structure the agreement in such a way to preclude or substantially hinder the trustee from making a *prima facie* case pursuant to Bankruptcy Code section 547.

## **II. Substantive bankruptcy laws and procedural rules that apply upon a bankruptcy filing**

### **The Bankruptcy Rules**

First of all, it is important to note that, while the Federal Rules of Evidence apply to proceedings in bankruptcy court, any litigator who appears in bankruptcy court will need to get acquainted with the Federal Rules of Bankruptcy Procedure (the “Bankruptcy Rules”). The Bankruptcy Rules are similar to and in many respects mirror precisely many of the Federal Rules of Civil Procedure (“FRCP”); however, if you have a case in bankruptcy do not just assume that the procedural rules will be exactly the same.

Disputes are generally decided in bankruptcy court in two contexts: (a) adversary proceedings and (b) contested matters. Contested involuntary proceedings are a third category, and those are governed by Bankruptcy Rule 1018. But most disputes are either adversary proceedings or contested matters, and different rules apply depending on the characterization of the dispute. Bankruptcy Rule 7001 provides a list of proceedings that must be commenced as an adversary proceeding – the list includes proceedings such as most actions to recover money or property and most actions seeking injunctive or equitable relief. If you are seeking the type of relief contemplated by Bankruptcy Rule 7001, you will need to comply with all of the “7000 series” of Bankruptcy Rules. Many of these rules simply adopt their counterpart within the FRCP, but other rules such as Bankruptcy Rule 7004 on service of process (which is a requirement for an adversary proceeding but not a contested matter) differ in key respects from their FRCP counterparts – Bankruptcy Rule 7004(b), for instance, provides for service of process by first class mail (other than service on an insured depository institution), in contrast to FRCP 4.

For contested matters, which are basically all disputes not covered by Bankruptcy Rules 7001 or 1018, relief needs to be requested by motion. In a contested matter, you do not need to comply with all of the 7000 series of rules, but you do need to comply with some of them. Bankruptcy Rule 9014(c) contains the list of rules from the 7000 series that apply to contested matters. Although an adversary proceeding, once initiated, is assigned a case number in addition to the main bankruptcy case number, a contested matter does not receive an additional case number – it is simply treated as a motion within the main bankruptcy case. But although a motion initiating a contested matter does not, like an adversary proceeding, require service of process, many of the procedural rules do apply, including the rules on discovery, summary judgment and enforcement. Some examples of contested matters include motions to lift or modify the automatic stay, motions for adequate protection, and motions to sell assets of the estate. Evidentiary hearings on these motions often are more complex and take longer to try than certain adversary proceedings.

### **Statutes of Limitations**

One threshold issue a litigator faced with a bankruptcy scenario needs to consider is the statute of limitations associated with their lawsuit. Under certain circumstances, Bankruptcy Code section 108 allows for the extension of time of any statute of limitation to commence an action that the debtor could have taken before filing its bankruptcy petition for two years after the petition date, unless the applicable statute of limitation would expire later under applicable non-bankruptcy law. Section 108 states in pertinent part:

- (a) If applicable nonbankruptcy law, an order entered in a nonbankruptcy proceeding, or an agreement fixes a period within which the debtor may commence an action, and such period has not expired before the date of the filing of the petition, the trustee may commence such action only before the later of —

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<sup>1</sup> 11 U.S.C. § 547.

- (1) the end of such period, including any suspension of such period occurring on or after the commencement of the case; or
  - (2) two years after the order for relief.
- (b) Except as provided in subsection (a) of this section, if applicable nonbankruptcy law, an order entered in a nonbankruptcy proceeding, or an agreement fixes a period within which the debtor or an individual protected under section 1201 or 1301 of this title may file any pleading, demand, notice, or proof of claim or loss, cure a default, or perform any other similar act, and such period has not expired before the date of the filing of the petition, the trustee may only file, cure, or perform, as the case may be, before the later of —
- (1) the end of such period, including any suspension of such period occurring on or after the commencement of the case; or
  - (2) 60 days after the order for relief.
- (c) Except as provided in section 524 of this title, if applicable nonbankruptcy law, an order entered in a nonbankruptcy proceeding, or an agreement fixes a period for commencing or continuing a civil action in a court other than a bankruptcy court on a claim against the debtor, or against an individual with respect to which such individual is protected under section 1201 or 1301 of this title, and such period has not expired before the date of the filing of the petition, then such period does not expire until the later of —
- (1) the end of such period, including any suspension of such period occurring on or after the commencement of the case; or
  - (2) 30 days after notice of the termination or expiration of the stay under section 362, 922, 1201, or 1301 of this title, as the case may be, with respect to such claim.

### **The Automatic Stay**

Most litigators know that when a bankruptcy petition is filed, the automatic stay is imposed, but the impact of the automatic stay is not always simple to navigate. The automatic stay prohibits the commencement, continuation, and/or enforcement of most acts against the bankruptcy estate or property of the estate. There are many exceptions to the automatic stay contained in section 362(b) of the Bankruptcy Code. For example, the automatic stay does not prohibit the commencement or continuation of many forms of family law litigation (such as custody disputes), or the commencement or continuation of an action or proceeding by a governmental unit. However, if there is ever any doubt about whether the automatic stay applies, do not guess! This is not a situation where it is better to ask for forgiveness than to ask for permission. First of all, depending on the jurisdiction you are in, actions taken in violation of the stay are either void ab initio or voidable. Further, if the debtor is an individual, actions taken in willful violation of the stay could result in an award of not only actual damages including costs and attorney's fees but also punitive damages. Suffice it to say, then, that when in doubt you should seek relief from the automatic stay before taking any action that could violate the stay; such a request is done by motion, so it is a contested matter rather than an adversary proceeding.

The automatic stay is an integral part of the Bankruptcy Code because it helps to preserve the status quo. Filing a bankruptcy petition automatically stays any pending litigation. Indeed, the automatic stay prevents a chaotic and uncontrolled scramble for a debtor's assets by creditors.

The effect of the automatic stay on pending litigation is sometimes confusing for non-bankruptcy practitioners. If the action was commenced against the debtor, as a general rule, it is stayed regardless of its current posture. If the debtor is the plaintiff and there are no counterclaims seeking affirmative relief, the pre-petition action is not stayed. State and federal courts have concurrent jurisdiction to decide the effect of the stay.

The automatic stay does not bar a party from commencing an adversary or contested proceeding against the debtor in the bankruptcy court.<sup>2</sup> Section 362(d) of the Bankruptcy Code and the Federal Rule 4001 of Bankruptcy Procedure create a procedure for creditors to seek relief from the stay. Upon the request of a party-in-interest and after notice and hearing, the court shall grant relief from the stay for cause, including lack of adequate protection of an interest in property of such party in interest.

With respect to a hearing on relief from the automatic stay, actual trial procedures vary in each court. The court must hold a preliminary hearing within thirty (30) days of the filing of such a motion. Some courts treat the first hearing as a preliminary hearing, but a final hearing must be commenced within thirty (30) days of any preliminary hearing, unless the movant consents to an extension. The stay may terminate if the debtor fails to request a timely hearing, the court fails to schedule a hearing, the court adjourns a scheduled hearing on its own motion, or the court holds a hearing but issues no order of continuance within the thirty-day period.

The party requesting relief from the automatic stay has the burden of proof on the issue of the debtor's equity in property, while the party opposing relief from stay has the burden on all other issues. However, the moving party must first establish a prima facie case in support of its request for relief from the automatic stay.

### **Removal**

One alternative to seeking relief from the stay, however, is to remove the pending lawsuit pursuant to 11 U.S.C. § 1452. Pursuant to that section, any party may remove “any claim or cause of action in a civil action other than a proceeding before the United States Tax Court or a civil action by a governmental unit to enforce such governmental unit's police or regulatory power, to the district court for the district where such civil action is pending, if such district court has jurisdiction of such claim or cause of action under section 1334 of this title.” 11 U.S.C. § 1452(a) The court to which such a claim is removed may remand “on any equitable ground,” and such determination is not appealable. 11 U.S.C. § 1452(b).

Bankruptcy Rule 9027 governs the procedure for bankruptcy removals and remands. Among other important provisions, Bankruptcy Rule 9027 sets the deadlines for filing a bankruptcy removal. If the action was initiated pre-petition, Bankruptcy Rule 9027(a)(2) provides that a removal may be filed within the longest of (A) 90 days after the order for relief, (B) 30 days after entry of an order terminating the automatic stay if the action is subject to the automatic stay (i.e., if the action seeks relief from the debtor), or (C) 30 days after a chapter 11 trustee is appointed (but not later than 180 days after the order for relief). If the action is initiated post-petition, Bankruptcy Rule 9027(a)(3) provides that a removal may be filed within the shorter of (A) 30 days after receipt, through service or otherwise, of a copy of the initial pleading setting forth the claim or cause of action to be removed, or (B) 30 days after receipt of the summons if the initial pleading has been filed with the court but not served with the summons. Although section 1452 and Bankruptcy Rule 9027 appear to clearly state that such a removal must be filed in the district court in the district where the action is pending, bankruptcy removals often get filed in the district where the bankruptcy is pending, and often the removals are filed in bankruptcy court. The propriety of such filings is often judged based on local rules and local practice, so be sure to review the local rules with respect to bankruptcy removals in addition to Bankruptcy Rule 9027.

### ***Stern v. Marshall* – Constitutional authority of the bankruptcy court under attack**

Notwithstanding the painstaking specificity with which certain statutes and rules appear to provide bankruptcy courts with authority to hear certain matters, the constitutional authority of the bankruptcy court is currently under attack. In bankruptcy proceedings, 28 U.S.C. § 157 allocates decision-making power over adversary proceedings and contested matters to both the district court and the bankruptcy judges within the district.<sup>3</sup> Upon referral by the district court, the statute authorizes bankruptcy judges to hear and determine core proceedings, subject to ordinary appellate review.<sup>4</sup> For noncore proceedings, bankruptcy judges may only hear the proceeding and submit proposed findings of fact and conclusions of law to the district court for de novo review.<sup>5</sup> If the parties to the proceeding consent, the bankruptcy

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<sup>2</sup> The majority of courts have held that violations of the stay are void *ab initio*. This can be a significant distinction for litigation. However, in *Picco v. Global Marine Drilling Co.*, 900 F.2d 846 (5th Cir. 1990), the Court of Appeals for the Fifth Circuit held that an action commenced during the pendency of the automatic stay was voidable, not void—a minority position.

<sup>3</sup> 28 U.S.C. § 157.

<sup>4</sup> *Id.*

<sup>5</sup> 28 U.S.C. § 157(c)(1).

judge may hear and determine a noncore proceeding, including entering a final order or judgment, subject to ordinary appellate review.<sup>6</sup>

*Stern v. Marshall*<sup>7</sup> involved an adversary proceeding by a creditor to declare his defamation claim nondischargeable and a counterclaim by the debtor's estate for tortious interference. The Court held that although there was statutory authority for the bankruptcy judge to decide the counterclaim – since it was listed as a core proceeding under 28 U.S.C. § 157(b)(2)(C) – there was no constitutional authority for the bankruptcy judge to do so because an Article III court was required.<sup>8</sup> The Court stated that there would be constitutional authority for the bankruptcy court to determine the counterclaim only if the counterclaim stemmed from the bankruptcy case itself or “would necessarily be resolved in the claims allowance process.”<sup>9</sup>

Although *Stern* focused on a relatively narrow aspect of bankruptcy judges' authority, courts around the country have struggled with interpreting the decision and its implications. As a result of the *Stern* ruling, litigants are using the decision to call into question bankruptcy judge's authority to hear and determine a myriad of matters that they have historically presided over. Indeed, *Stern* will affect bankruptcy litigation strategies of both companies attempting to reorganize their affairs and trustees pursuing claims on behalf of the estate. This is especially true of fraudulent transfer and fiduciary duty litigation – two of the most common types of litigation commenced in bankruptcy courts. Any litigator who handles an adversary proceeding in bankruptcy will need to consider the implications of *Stern* and its progeny.

### III. D&O and other insurance issues

Directors and Officers (“D&Os”) of financially distressed companies face a heightened risk of personal liability. Difficult decisions made by a struggling company's management may be vulnerable to second-guessing by a struggling company's management. These decisions may also be scrutinized post-filing by a trustee seeking a recovery from pre-bankruptcy management for the company's failure. Executives of struggling companies also face the significant practical concern that the bankrupt company may not have the financial wherewithal to meet its indemnification obligations.

Absent careful front-end planning by the company during the process of obtaining insurance, a bankruptcy filing can present challenges for individual directors and officers seeking access to D&O policy funds. A common question that arises is: to what extent are the proceeds of the D&O policy property of the estate?

Many courts consider the D&O policy and its proceeds separately in determining whether they are the property of the bankruptcy estate of the insured debtor.<sup>10</sup> In that regard, a majority of courts consider D&O policies property of the debtor's estate. The larger issue is whether D&O policy proceeds are the property of the estate rather than the policy itself. Courts have developed divergent approaches to answer this question that may depend on one or more of the following considerations: (1) whether the operative policy provides entity coverage to the bankrupt corporation; (2) whether the bankrupt corporation has a legitimate interest in the policy proceeds; and (3) whether the policy proceeds are the largest available asset in the bankruptcy proceeding.

Numerous courts have held that, where the debtor company does not have a “direct interest” in the proceeds of a D&O policy, the proceeds are not property of the bankruptcy estate.<sup>11</sup> Other courts have found, however, that where there are claims for indemnification coverage under the applicable insurance agreement, the D&O policy proceeds may be property of the bankruptcy estate.<sup>12</sup> These courts reason that payments to the directors and officers for defense expenses would deplete the policy limits, thereby increasing the debtor's exposure to indemnification claims

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<sup>6</sup> 28 U.S.C. § 157(c)(2).

<sup>7</sup> 131 S. Ct. 2594 (2011).

<sup>8</sup> *Id.* at 2608.

<sup>9</sup> *Id.* at 2618.

<sup>10</sup> See, e.g., *La. World Exposition, Inc. v. Fed. Ins. Co. (In re La. World Exposition, Inc.)*, 832 F.2d 1391, 1399 (5th Cir. 1987) (“There are a great many bankruptcy cases holding that liability insurance policies that provide coverage for the bankrupt's liability belong to the bankrupt's estate.”) (emphasis in original) (collecting cases); *Ochs v. Lipson (In re First Cent. Fin. Corp.)*, 238 B.R. 9, 16 (Bankr. E.D.N.Y. 1999) (“[W]hen a corporation becomes the subject of a bankruptcy case, its insurance policies become property of the bankruptcy estate.”).

<sup>11</sup> See, e.g., *La. World Exposition, Inc. v. Fed. Ins. Co. (In re La. World Exposition, Inc.)*, 832 F.2d 1391 (5th Cir. 1987); *In re MCSi, Inc., Secs. Litig.*, No. C-3-03-015 (S.D. Ohio Feb. 26, 2004); *Youngstown Osteopathic Hosp. Ass'n v. Ventresco (In re Youngstown Osteopathic Hosp. Ass'n)*, 271 B.R. 544 (Bankr. N.D. Ohio 2002); *Imperial Corp. of Am. v. Milberg, Weiss, Bershad, Spechtrie & Lerach (In re Imperial Corp. of Am.)*, 144 B.R. 115 (Bankr. S.D. Cal. 1992); *In re Daisy Sys. Secs. Litig.*, 132 B.R. 752 (N.D. Cal. 1991); *Zenith Lab., Inc. v. Sinay (In re Zenith Lab. Inc.)*, 104 B.R. 659 (Bankr. D.N.J. 1989).

<sup>12</sup> See *In re Leslie Fay Cos., Inc.*, 207 B.R. 764 (Bankr. S.D.N.Y. 1997); *Circle K Corp. v. Marks (In re Circle K Corp.)*, 121 B.R. 257 (Bankr. D. Ariz. 1990).

in other litigation.<sup>13</sup> Thus, according to these courts, the debtor's interest in being reimbursed by the insurer for the amounts it must indemnify its directors and officers is sufficient to hold that the policy's proceeds are an asset of the bankruptcy estate.

If policy proceeds are deemed property of the estate, directors and officers may be precluded from accessing those proceeds without court approval. Property of the estate determination may depend in part on type of D&O policy. This determination may also depend on jurisdiction. Because individual executives may not be subject to the automatic stay, the practical consequences can be very significant for individuals who are relying on insurance funds to cover their litigation costs.

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<sup>13</sup> See, e.g., *Circle K Corp.*, 121 B.R. at 261-62.