

Your client filed for bankruptcy: What now?

A look at how a PI claim can become an asset in a bankruptcy estate that may be used to pay creditors

By James Stang

You are about to take on a client who has a large personal-injury claim. You smartly ask whether she has filed a bankruptcy petition in the past, (which, by the way, you should ask every potential client). You learn that she has. What is the legal effect on her claim? What steps should you take? What is the legal effect of the bankruptcy on her claim?

As a hypothetical, suppose your potential client was one of the women sexually abused by two doctors formerly employed by the UC Regents (312 of whom filed suit in actions consolidated under *Jane Doe et al. v. the Regents of the University of California et al.*, Lead Case No. 19STCV20594, in the Los Angeles County Superior Court). The abuse in those cases dates back to 1983, but in September 2020, the statute of limitations for such sexual assaults was reopened until December 31, 2021, and these were among the lawsuits brought about as a result of that legislation.

A settlement agreement was reached resolving those claims. Your potential client would be entitled to significant compensation. Before the litigation, however, she filed a chapter 7 bankruptcy petition in an attempt to discharge overwhelming medical costs. Counsel for the UC Regents learns of the bankruptcy and contends that she does not actually own her claim and may not be entitled to receive the settlement funds.



A refresher on bankruptcy basics

To understand why requires an introduction to some bankruptcy basics. When a debtor files a chapter 7 petition seeking a bankruptcy discharge, an "estate" is created that consists, in essence, of all of the debtor's property of whatever nature and wherever located, as of the date that the petition is filed. (11 USC § 541(a).) A debtor's pre-petition personal-injury claim is property of the bankruptcy estate under section 541 of title 11 of the United States Code. (*Sierra Switchboard Co. v. Westinghouse Elec. Corp.*, 789 F.2d at 707-09; *see also Bronner v. Gill* 9th Cir. BAP 1992) 135 B.R. 645, 647 ["A debtor's claim for injuries to the person, even if unliquidated at the time the petition was filed, is property of the bankruptcy estate as of the commencement of the case."].)

Once the petition is filed, a chapter 7 trustee is appointed as the legal representative of that estate. Trustees are appointed under the auspices of the bankruptcy court to represent the interests of creditors of the debtor. The primary role of a chapter 7 trustee, at least in cases with assets, is to liquidate the debtor's nonexempt assets in a manner that maximizes the return to the debtor's unsecured creditors, to administer the claims process, including objecting to claims when appropriate, and make distributions to creditors.

With the chapter 7 petition, a debtor is required to file Schedules of Assets and Liabilities and a Statement of Financial Affairs (collectively referred to as "Schedules"). Assets to be scheduled are, as noted, all property in which the debtor has any legal, equitable, or future interest, including intangibles, a term that covers causes of action; as well, the Statement of Financial Affairs asks for a description of any "legal actions."

Under the statutory scheme, debtors do not receive any property from the bankruptcy estate unless all creditors are paid

Copyright © 2023 by the author.
For reprint permission, contact the publisher: **www.plaintiffmagazine.com**



in full. (11 U.S.C. § 726(a)(6).) In a typical chapter 7 case, the assets are not nearly sufficient to pay creditors in full. In a great many cases, in fact, there are no assets that are not exempt or subject to liens, and so nothing for a trustee to administer. In such cases the trustee files a "no asset report" and creditors are notified not to file proofs of claim, unless and until such time as the trustee recovers assets for distribution (in which case the Bankruptcy Court provides notice to creditors to file proofs of claim).

The debtor receives a discharge of those debts that are legally dischargeable. Debts not discharged include debts for alimony and child support, most tax debt, most student-loan debt, debts for willful and malicious injury by the debtor, and others. (11 U.S.C. § 523(a).) The discharge can also be revoked on grounds that include the intentional failure to report or surrender property of the estate. (11 U.S.C. § 727(d).)

A pre-bankruptcy PI claim becomes an asset of the bankruptcy estate

Which brings us back to your potential client. Assuming the injury occurred before the bankruptcy, she had a claim at the time her petition was filed, whether she was aware of the claim or not, and even if, at that time, the statute of limitations had run. With the reopening of the statute, that pre-bankruptcy claim sprang back to life, and became a valuable asset that could be used to pay creditors of the bankruptcy estate. It would be her responsibility to report it; indeed, an intentional failure to do so could be cause for revocation of her discharge.

Your initial task, then, is to find the docket of the bankruptcy case, which you will find on the Bankruptcy Court's ECM or Pacer system, and first determine whether the case is still open or whether it has been closed. If it is still open, you will contact the chapter 7 trustee to advise them of the existence of this asset. As the representative of the bankruptcy estate, the chapter 7 trustee "owns" the claim and is the person with authority to make all decisions concerning its prosecution and settlement. For instance, as the "owner" of the claim, the trustee will need to move for court approval of any settlement, which the court will typically approve so long as it is within a broad range of reasonableness. (*In re A & C Properties* (9th Cir. 1986) 784 F.2d 1377.)

Accordingly, discussions must be had concerning how the trustee will handle the claim, including who the trustee will hire to prosecute the claim, and on what terms it might be settled. To the extent the recovery exceeds the amount needed to pay creditors, the debtor will have a significant interest in the outcome, since after payment of all claims, "[p]roperty of the estate shall be distributed . . . to the debtor." (11 U.S.C. § 726(a)(1)-(6).) That being the case, the trustee will in all likelihood be solicitous of the debtor's input and opinions concerning the claim.

If the case was previously a no-asset case, the trustee will send a notice to creditors advising that there may be a dividend in the case and that they need to file proofs of claim before a certain bar date. The debtor will also have an interest in objecting to claims that are invalid or excessive, and by statute, has standing to do so. (11 U.S.C. § 502(a).) If a recovery is made on the sexual-abuse claim before claims have been fully administered, and your client has an immediate need for funds, the trustee may be willing to make an interim, partial distribution to her, reserving an amount conservatively estimated to be sufficient to pay all allowed claims as well as the trustee's estimated administrative expenses in the case. Bankruptcy courts have authority to approve interim distributions under section 105 of the Bankruptcy Code. (See *In re Bird*, 565 B.R. 382, 400 (Bankr. S. D. Tex. 2017 ["[T]he Code does not bar an interim distribution, and when it benefits the estate to do so, the Court is authorized to approve any interim distribution using its authority pursuant to § 105(a)"].)

If the bankruptcy case has been closed, the asset must be reported to the United States Trustee ("UST"), which has an office in each district where a bankruptcy court is located. The UST will decide whether the case should be reopened (discharged trustees do not have standing to re-open cases). If the case is reopened, the UST will appoint a trustee (likely the same trustee as before if he or she is still serving as a trustee). You will have the same discussions described above with the newly appointed or reappointed trustee. If the UST decides not to reopen the case, i.e., it believes the asset is not worth enough to justify reopening the case in order to administer it, the asset still nominally belongs to the bankruptcy estate, but practically, the decision not to reopen will put an end to the issue of whether the plaintiff/discharged debtor can prosecute the claim.

Exempt assets – making the right claim

In addition to alerting the chapter 7 trustee or UST, you will want to check the Schedules. You will want to file amended Schedules to reflect the existence of the claim. The Schedules will also give you an idea of what her liabilities were at the time, as these are the debts that will need to be satisfied from the client's recovery, by settlement or otherwise. You will also be looking at her Schedules to see what exemptions she claimed. Not all of a debtor's property becomes property of the bankruptcy estate. The Bankruptcy Code allows an individual debtor to protect some property from the claims of creditors because it is exempt either under federal bankruptcy law or under the laws of the debtor's home state. (11 U.S.C. § 522(b).) Among the Schedules that would have been filed with the petition is a schedule of property claimed to be exempt. If there is any doubt at all whether the recovery on the claim will be enough to pay creditors, including the chapter 7 trustee's expenses incurred administering the case, then claiming the right exemptions will be critical.

Copyright © 2023 by the author.
For reprint permission, contact the publisher: **www.plaintiffmagazine.com**



Under the federal exemptions, up to $27,900 of an award on account of personal bodily injury (not including pain and suffering or compensation for actual pecuniary loss) may be claimed as exempt. (11 U.S.C. § 522(d)(11)(D).) But many states have taken advantage of a provision in the Bankruptcy Code that permits each state to adopt its own exemption law in place of the federal exemptions. In some jurisdictions, the individual debtor has the option of choosing between a federal package of exemptions or the exemptions available under state law. In California, a debtor may not elect the federal exemptions, but must select from one of two sets of state law exemptions to choose from, provided for in sections 703 and 704 of the Code of Civil Procedure.

Those two alternative sets of exemptions have very different provisions for personal-injury claims and awards. On its face, the section 704 set of exemptions appears more liberal in this respect, because section 703 exempts only $31,950 of personal-injury recoveries (and potentially a "wildcard exemption" in the same amount, to the extent the homestead exemption is not used). (Code Civ. Proc., § 703.140, subd. (b).

Section 704, in contrast, provides that "*a cause of action for personal injury is exempt* without making a claim" (except to the extent there is a lien in a pending action). (Code Civ. Proc., § 704.140, subd. (a) (emphasis added).) Subsection (b) provides "Except as provided in subdivisions (c) and (d), *an award of damages or a settlement arising out of personal injury is exempt to the extent necessary for the support of the judgment debtor and the spouse and dependents of the judgment debtor*. (Code Civ. Proc., § 704.140, subd. (b) (emphasis added).) Subsection (c) is not relevant here, and subsection (d) essentially applies the same "necessary for support" standard to periodic payments from the settlement of a personal injury claim.

This raises numerous questions. What if she took the section 703 exemptions when the section 704 exemptions would have been more beneficial? Can she amend her schedules to switch from one to the other? The answer is yes; exemptions can be amended upon notice to creditors, who have 30 days to object. Federal Rule of Bankruptcy Procedure 1009 grants debtors the right to freely amend their bankruptcy petitions, including their exemption schedules. The rule states: "A voluntary petition, list, schedule, or statement may be amended by the debtor as a matter of course at any time before the case is closed." (Fed. R. Bankr. P. 1009.) "This right to amend includes the right to amend the debtor's list of property claimed exempt." (*In re Goswami* (9th Cir. BAP 2003) 304 B.R. 386, 393.) An objection might be sustained, however, in situations where actions have been taken in reliance on the exemptions as originally scheduled. (See, e.g., *In re Knapp*, 283 B.R. 819, 820 (Bankr. W.D. Pa. 2002) [trustee had already settled a lawsuit in reliance on lack of an exemption claim].)

Is there significance to the fact that section 704.140, subdivision (a) exempts a "cause of action" without any limitation to the amount "necessary for support," while section 704.140, subdivisions (b) and (d) (pertaining to awards and settlement payments) do contain such a limitation? The answer is no; rather, that limitation is essentially read into section 704.140, subdivision (a). (*Gose v. McGranahan (In re Gose*) (9th Cir. BAP 2004) 308 B.R. 41, 48 ["the bankruptcy court did not err in reading the subsections together; both provisions govern the exemption in the personal injury claim."].)

Necessary support

What factors are taken into account in determining how much is necessary for support? There is no set formula. Factors to be considered include "anticipated living expenses and income; the age and health of the debtor and his or her dependents; the debtor's ability to work and earn a living; the debtor's training, job skills and education; the debtor's other assets and their liquidity; the debtor's ability to save for retirement; and any special needs of the debtor and his or her dependents." (*In re Altmiller-Rubio*, No. 08-17274-B-13, 2011 Bankr. LEXIS 5570, at *10–14 (Bankr. E.D. Cal. Sep. 13, 2011) (citation omitted). See also, *Parker v. Smith (In re Smith)*, No. EC-16-1140-BJuTa, 2017 Bankr. LEXIS 1119 (9th Cir. BAP Apr. 24, 2017) [taking holistic view of debtor's financial situation]; but see, *In re Haaland*, 89 B.R. 845, 847-48 (Bankr. S.D. Cal. 1988) [limiting exemption to amount needed to replace future earnings where a debtor has been disabled from working].) The burden of proof is on the debtor. (*Parker v. Smith*, 2017 Bankr. LEXIS at *11.)

Theoretically, one option could be to attempt to dismiss the bankruptcy case altogether. A bankruptcy court may dismiss a chapter 7 petition "for cause." (11 U.S.C. § 707(a).) A debtor seeking dismissal of a chapter 7 case has the burden to demonstrate that creditors will not be prejudiced by dismissal. (*Cabral v. Rund* (*In re Cabral*), No. CC-20-1061-LST, 2020 Bankr. LEXIS 3145, at *5 (9th Cir. BAP Nov. 5, 2020).) "[T]he cases indicate almost universally that courts should approve voluntary case dismissals only where the payment of creditors is provided for, and reasonably prompt and certain." (*Id*. at *11 (citations omitted).)

Where the bankruptcy court loses jurisdiction, the trustee is relieved of the obligation to ensure payment to the creditors, and conversely, the creditors lose the guarantee of repayment, this lost guarantee constitutes "plain legal prejudice" absent affirmative consent of creditors. (*Id*. at *13.) The creditors that must be paid include the chapter 7 trustee and his or her counsel, and anyone else who incurred expenses administering the case (known as "administrative expenses"). (*In re Kaur*, 510 B.R. 281, 286 (Bankr. E.D. Cal. 2014).) Still, if the debtor had few creditors and can satisfy the court that all will be paid, including the trustee, dismissal might have utility as a means of avoiding the further accrual of administrative expenses.

Copyright © 2023 by the author.
For reprint permission, contact the publisher: **www.plaintiffmagazine.com**



In summary, if your client filed a chapter 7 bankruptcy petition after the personal injury occurs, the claim is no longer owned or controlled by her, but by the chapter 7 trustee. She must report the existence of the claim to the chapter 7 trustee or UST, lest her discharge be revoked for failure to report assets. If her claim is more than *de minimis*, the case if closed will likely be reopened. If her potential recovery is larger than her debts at the time, she has a right to the surplus, and you will likely find the chapter 7 trustee very accommodating as to how she would like the claim to be prosecuted and/or settled. And if her potential recovery is less than the amount needed to pay her debts, you will want to ensure that she claims the exemptions that preserve the greatest amount of that recovery for her benefit.

James Stang, a founding partner of Pachulski Stang Ziehl & Young, *has dedicated his restructuring practice to helping plaintiffs against institutions that file bankruptcy in an attempt to evade liability. Mr. Stang is a fellow of the American College of Bankruptcy.*



Stang

Copyright © 2023 by the author.
For reprint permission, contact the publisher: **www.plaintiffmagazine.com**