THE EFFECT OF BANKRUPTCY ON LITIGATION: WHAT EVERY CITY ATTORNEY SHOULD KNOW TO AVOID PITFALLS AND SANCTIONS

By

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Bankruptcy shapes our daily lives in numerous ways. Over the past several years, bankruptcy proceedings have impacted such diverse aspects as travel, electricity, shopping habits, professional sports, and telecommunications. The affects of bankruptcy have rippled dynamically through existing industries around the globe. Not surprisingly, bankruptcy proceedings can have profound consequences for litigation.

The purpose of this paper is to provide a litigator with some basic guidelines for understanding how Chapter 7 and Chapter 11 bankruptcies create potential quandaries for lawyers representing clients/creditors in claims against a bankrupt (or soon to be bankrupt) defendant. The scenarios covered here are three-fold: 1) the defendant files for bankruptcy pre-litigation; 2) the defendant files for bankruptcy during litigation; and 3) the litigation commences post-petition.

I. THE BASICS

The word "bankruptcy" signals impending doom for most litigators. And while this knee-jerk reaction is not without merit, proper channels exist for preserving a client's claim if the attorney understands the necessary steps involved. Attorneys should first acquaint themselves with fundamental bankruptcy terminology in order to competently discuss plausible hurdles facing clients.

A. Terminology:

- **Debtor** - A party who files a voluntary petition or party against whom an involuntary petition is filed in the bankruptcy court.[1]

- **Creditor** - A party who has a claim against the debtor that arose at the time of or before the bankruptcy petition was filed.[2]

- **Automatic Stay** - Upon the filing of the bankruptcy, without the need of a court order, a injunction applies stopping all suits and collection efforts against the debtor.[3]

- **Executory Contract** - While much more complicated and always part of disputes in bankruptcy, an executory contract exists where performance is still due under the contract and failure to perform by either party would excuse performance by the other because a breach of contract results.[4]

- **Pre-Petition Claim** - A claim that arises prior to the Debtor filing for bankruptcy.[5]

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1 11 U.S.C. § 101(13) (2004).
2 11 U.S.C. § 101(10) (2004).
3 11 U.S.C. § 362 (2004).
4 11 U.S.C. § 365 (2004).
5 *See generally, In re Reed*, 179 B.R. 353 (Bankr. S.D. Ga. 1995).

- **Post-Petition Claim** - A claim that arises after the Debtor files for bankruptcy.[6]

- **Proof of Claim** - Statement filed under oath and under penalty of perjury by a creditor in which the creditor sets forth the amount owed and sufficient detail to support the basis of the creditor's claim.[7]

- **Secured Claim** - A claims backed by pledged collateral or a security agreement.[8]

- **Unsecured Claim** - A claim not backed by pledged collateral or a security agreement.[9]

- **Unliquidated Claim** - A claim that has not been finally determined either as to liability or amount of damages.[10]

- **Chapter 7** - Liquidating bankruptcy.[11]

- **Chapter 11** - Reorganizing bankruptcy.[12]

B. Order of Payment

In addition to recognizing basic bankruptcy definitions, litigation attorneys need to familiarize themselves with the order in which the bankruptcy estate distributes payments. Secured creditors have priority; thus, the bankruptcy estate pays secured creditors first.[13] Super-priority claims receive the next distribution.[14] Then, the estate must pay administrative expenses.[15] The unsecured creditors receive payment next,[16] and finally, anything leftover goes to equity holders.[17]

With a basic grasp of bankruptcy terminology and payment schedules, litigators become better equipped to address the initial concerns of their creditor clients. For instance, upon notification that a bankruptcy filing has occurred, a litigator should be prepared to answer the client's various questions. Questions likely to arise include:

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6 *See generally, In re Eagle Bus Mfg*., 158 B.R. 451 (S.D. Tex. 1993).
7 11 U.S.C. § 501 (2004).
8 BLACK'S LAW DICTIONARY 241 (7th ed. 1999).
9 BLACK'S LAW DICTIONARY 241 (7th ed. 1999).
10 BLACK'S LAW DICTIONARY 240 (7th ed. 1999).
11 11 U.S.C. §§ 701 – 784 (2004).
12 11 U.S.C. §§ 1101 – 1171 (2004).
13 11 U.S.C. § 502 (2004).
14 11 U.S.C. § 507(b) (2004).
15 11 U.S.C. §§ 503 & 507(a)(1) (2004).
16 11 U.S.C. § 507(a)(2) (2004).
17 11 U.S.C. § 507 (2004).

- Is the case worth pursuing?
- What are the immediate affects of the bankruptcy filing?
- If I have already filed a lawsuit, may I continue the lawsuit?
- If I have not filed a lawsuit, may I do so?
- What are the long-term affects of this filing?

C. The Most Important Question: Is The Case Worth Pursuing?

The viability of a creditor's claim typically depends on the debtor's financial position. Accordingly, the litigator must use some method or means of determining the debtor's net worth in order to answer this question. Various services exist, providing a wide-range of options from extensive financial analysis, costing thousands of dollars, to basic financial information that can cost as little as $50.[18]

To further determine the debtor's net worth, a litigator needs a copy of the bankruptcy schedules, which consists of an assets and liabilities list prepared and produced by the debtor.[19] Irrespective of the bankruptcy chapter filed, a creditor's attorney needs a list of the debtor's secured creditors and the amounts the debtor owes each.

Another essential list that a litigator must obtain consists of the debtor's 20 largest unsecured creditors.[20] This list allows the attorney to compare the client's claim with that of the debtor's 20 largest unsecured creditors to determine the likelihood of recovery given the debtor's similarly situated liabilities.

Finally, if the above noted documents do not provide enough information to properly evaluate the financial position of the debtor, the litigator can then schedule a deposition of the debtor's financial representative.[21]

Notably, attorneys should exercise caution and be cognizant that various information sources differ in reliability and detail. For instance, because a Dun & Bradstreet report is compiled from information provided by the debtor company, it may not be as comprehensive as a UCC search, which yields a detailed list of secured creditors' by order of payment.[22] Nonetheless, the initial asset search helps establish the debtor's financial position so the creditor client can make an informed decision on how to proceed with its claim.

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18 Depending on the size of the claim, a litigator can determine the debtor's net worth by utilizing a private investigator's services, conducting a UCC search, or simply purchasing a Dun & Bradstreet report.

19 11 U.S.C. § 521 & 1106(a)(2) (2004).

20 FED. R. BANKR. P. R1007(d) (2004).

21 FED. R. BANKR. P R7030 (2004); *see also* FED. R. BANKR. P R2004 (2004).

22 Elizabeth Warren and Jay L. Westbrook, *Financial Characteristics of Businesses in Bankruptcy*, 73 AM. BANKR. L.J. 499, 530 n.59 (1999).

D. Jurisdiction

The filing of a bankruptcy petition can drastically alter the jurisdiction over a particular claim. Bankruptcy creates a new ground for federal jurisdiction.[23] In fact, Federal Bankruptcy courts possess national jurisdiction over cases related to or core to the bankruptcy proceeding.[24] Some examples of core proceedings include estate administration, claims allowances, obtaining credit, preferences, and fraud.[25] Attorneys should familiarize themselves with the bankruptcy courts' powers and jurisdiction and as with any court, determine the applicability of any local rules.

E. Non-Dischargeable Debts

Though the focus of this paper is on Business Bankruptcies, from time to time a litigator will need to know the basics when it comes to the dischargeability of individual consumer debts. Both Chapter 7 and 13 Bankruptcy rules generally prohibit discharge of the following debts[26]:

- Debts not listed on bankruptcy papers, whether intentionally or inadvertently absent from the filings;
- Child support, alimony, and other martial support type debts;
- Debts for personal injury or death caused by driving while intoxicated or under the influence of drugs;
- Student loans, although these may be dismissed if the debtor can prove it would be an undue hardship for to repay them;
- Any fines or penalties for violating the law, including traffic tickets and criminal restitution;
- Most federal, state, and local taxes, and any money borrowed on a credit card in order to pay those taxes; and
- Any debts that could not be discharged in a previous bankruptcy that was dismissed due to fraud or misfeasance.

If an individual debtor files Chapter 7 Bankruptcy, they will still be held responsible for repaying these debts after receiving their discharge. Under a Chapter 13 Bankruptcy filing, these debts must be paid in full and accounted for in the plan, or the balance will due and owing in full at the end of the plan's approval. It is important to note that even though these debts are generally non-dischargeable, the automatic stay still applies with regard to enforcement actions during the pendency of the bankruptcy proceeding.

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23 28 U.S.C. § 1334 (2004).

24 28 U.S.C. § 157 (2004).

25 28 U.S.C. § 157(b)(2) (2004).

26 Please note that this list is not comprehensive. Also, bankruptcy law regarding debt discharge is extremely complicated. I would suggest you contact an experienced bankruptcy attorney in your area to discuss these issues in more detail before proceeding.

In addition to the above, a bankruptcy judge may declare the following debts non-dischargeable in Chapter 7 bankruptcy cases if a creditor challenges the request to discharge them:

- Debts incurred based on fraudulent acts;
- Credit purchases in excess of $1,150 taken within 60 days of filing;
- Loans or cash advances in excess of $1,150 taken within 60 days of filing;
- Debts incurred as a result of willful or malicious injury to another person or another person's property;
- Debts from embezzlement, larceny, or breach of trust; and
- Debts owed under a divorce decree or marital settlement agreement, unless the Debtor would still not be able to pay them after bankruptcy or the benefit of having these discharged is found to outweigh the detriment to the ex-spouse.

II. DEBTOR FILES FOR BANKRUPTCY BEFORE YOU FILE SUIT

The first scenario examined involves a situation where the attorney has analyzed, researched, and prepared the client's claim, but before the actual filing of suit, the defendant files for bankruptcy. When this scenario occurs, the creditor client must be advised on how the bankruptcy filing impacts its potential claim.

A. How Does the Bankruptcy Filing Affect the Client's Case?

A bankruptcy filing, for all intents and purposes, freezes all actions concerning the debtor. This is called the automatic stay.[27] Technically, the automatic stay serves as an injunction that prevents the "commencement or continuation of litigation to recover a post-petition claim" after a filing for bankruptcy.[28] The stay effectively prevents creditors from continuing their efforts to collect on debts, to secure or improve their position on the debt, or to obtain any collateral they have related to the debt.[29] Likewise, the stay prevents enforcement of any pre-petition judgments against the property of the estate.[30] To the creditor's benefit, however, the stay protects the unexpired portion of the statute of limitations on a creditor's potential claim.[31]

Typically, the automatic stay does not prevent the creditor from pursuing claims against potential nondebtor co-defendants such as the officers and directors of a debtor corporation.[32] But attorneys should be aware that in limited or unusual circumstances

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27 11 U.S.C. § 362 (2004).

28 11 U.S.C. § 362(a)(1) (2004).

29 11 U.S.C. § 362; notes of Committee on the Judiciary Senate Rep. No. 95-989 (2004).

30 11 U.S.C. § 362(a) (2004).

31 11 U.S.C. § 108(c) (2004).

32 *See Lynch v. Johns-Manville Sales Corp*. 710 F.2d 1194, 1196-97 (6th Cir. 1983); *Williford v. Armstrong World Indus. Inc*., 715 F.2d 124, 126-27 (4th Cir. 1983); *Wedgeworth v. Fibreboard Corp.*, 706 F.2d 541, 544 (5th Cir. 1983); *Pitts v. Unarco Indus. Inc*., 698 F.2d 313, 314 (7th Cir. 1983) (per curiam); *Fortier v. Dona Anna Plaza Partners*, 747 F.2d 1324, 1330 (10th Cir. 1984).

courts can enjoin non-debtor third parties pursuant to Bankruptcy Code section 105 (a).[33] Courts have stated various reasons for enjoining non-debtor third party litigation, including protecting the reorganization process,[34] aiding the debtor's rehabilitation,[35]and distinguishing the identity of interests between the debtor and non-debtor third party.[36] Thus, the bankruptcy stay, in rare situations, can reach beyond the bankruptcy courtroom.

The automatic stay officially goes into effect immediately upon the petition's filing, staying all actions impacting the bankruptcy estate except criminal acts, family law matters, set-offs, and tax audits.[37] Only the bankruptcy court can modify, annul, terminate, or condition the stay.[38] And violations of the stay may result in actual damages, court costs, attorneys' fees, and possible punitive damages for the violating party.[39]

If a creditor's claim is not secured by an instrument or collateral, it is henceforth classified as an unsecured claim and slides towards the bottom of the bankruptcy payment ladder.[40] Moreover, the automatic stay halts any further settlement negotiations between the client and the debtor.[41] Realistically, the creditor client has limited options at this stage of the game. The client could imprudently wait until the bankruptcy's end for the stay to be lifted and then try to file the claim against the defendant/debtor. In a Chapter 7 proceeding, the stay expires when the debtor is discharged, and in a Chapter 11 proceeding, the stay expires when the case is closed or dismissed. Based upon the penultimate risk of completely losing the claim, however, this course of action is inadvisable.

Ordinarily, the client's most vital option requires filing a proof of claim in the bankruptcy proceeding and requesting relief directly from the bankruptcy court. The automatic stay applies solely to non-bankruptcy courts, so the filing or re-filing of a claim in the bankruptcy court will not violate the stay.[42] Thus, little excuse exists for failing to file a proof of claim. Most importantly, failure to timely file a proof of claim could result in the disallowance of the client's claims. So, regardless of whether the client ultimately decides to litigate, the proof of claim should be filed for the claim's future preservation.[43] This rule applies to abstracted judgments too. Even if a judgment has been abstracted, and the client's interest perfected, a proof of claim must still be filed with the bankruptcy court or the claim will likely be discharged.[44]

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33 *See A.H. Robbins Co., Inc. v. Piccinin*, 788 F.2d 994, 999 (4th Cir. 1986).

34 *LTV Corp. v. Miller*, 109 B.R. 613, 621 (S.D.N.Y. 1990).

35 *Johns-Manville Corp. v. Asbestos Litig. Group*, 33 B.R. 254, 263-64 (Bankr. S.D.N.Y. 1992).

36 *Piccinin*, 788 F.2d at 999.

37 11 U.S.C. § 362(b) (2004).

38 11 U.S.C. § 362(d) (2004).

39 11 U.S.C. § 362(h) (2004); *see also Tel-A-Communications Consultants, Inc. v. Auto-Use*, 50 B.R.250, 253-54 (B.C.D.C. Conn. 1985).

40 11 U.S.C. § 507 (2004).

41 11 U.S.C. § 362 (2004).

42 11 U.S.C. § 362 (2004).

43 FED. R. BANKR. P. 3002 (2004).

44 FED. R. BANKR. P. 3002(c)(3) (2004).

B. Seeking Relief from the Bankruptcy Court

The bankruptcy court has the power to terminate, annul, modify, or condition the automatic stay.[45] Thus, an unsecured creditor may request relief directly from the bankruptcy court.[46] The Bankruptcy Code's main statutory ground for requesting relief is "for cause."[47] No comprehensive list exists and exactly what constitutes "for cause" varies according to jurisdiction. Undoubtedly, though, the granting of relief to an unsecured creditor "for cause" occurs *only* under the most exceptional circumstances.[48] The court in *In re Curtis*[49] outlined various factors that courts have historically used in deciding whether to grant an unsecured creditor relief from the stay:

(1) Whether the relief will result in a partial or complete resolution of the issues.

(2) The lack of any connection with or interference with the bankruptcy case.

(3) Whether the foreign proceeding involves the debtor as a fiduciary.

(4) Whether a specialized tribunal has been established to hear the particular cause of action and that tribunal has the expertise to hear such cases.

(5) Whether the debtor's insurance carrier has assumed full financial responsibility for defending the litigation.

(6) Whether the action essentially involves third parties, and the debtor functions only as a bailee or conduit for the goods or proceeds in question.

(7) Whether litigation in another forum would prejudice the interests of other creditors, the creditors' committee and other interested parties.

(8) Whether the judgment claim arising from the foreign action is subject to equitable subordination under Section 510(c).

(9) Whether movant's success in the foreign proceeding would result in a judicial lien avoidable by the debtor under Section 522(f).

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45 11 U.S.C. § 362(d) (2004).

46 *Id*.

47 *Id*.

48 *Sonnax Indus., Inc. v. TRI Component Prods. Corp*., 99 B.R. 591, 595 (D. Vt. 1989) ("No unusual circumstances are present here, bearing in mind that the process of determining the allowance of claims is central to the usual function of the Bankruptcy Court in supervising the administration of the bankruptcy estate."), *aff'd*, 907 F.2d 1280 (2d Cir. 1990); *see also In re Stranahan Gear Co., Inc*., 67 B.R. 834, 837-38 (Bankr. E.D. Pa. 1986); *In re Pioneer Commercial Funding Corp*., 114 B.R. 45, 48 (Bankr. S.D.N.Y. 1990).

49 40 B.R. 795 (Bankr. D. Utah 1984).

(10) The interest of judicial economy and the expeditious and economical determination of litigation for the parties.

(11) Whether the foreign proceedings have progressed to the point where the parties are prepared for trial.

(12) The impact of the stay on the parties and the "balance of hurt."[50]

Practically speaking, unless an unsecured creditor has a claim against a debtor's insurers, guarantors, or sureties, the possibility of the court granting relief from the stay is minimal at best. And the costs of pursuing relief often far outweigh the chances of success.[51] The cost of seeking relief in complex claims (when the debtor challenges the relief motion) parallels that of a trial on the merits.[52] The relief motion invariably equates to a mini-trial against the debtor, while the other bankruptcy creditors also have the right to object to the motion for relief.[53]

C. Settlement

Occasionally, settlements between the estate and a third party occur in bankruptcy with approval from the bankruptcy court.[54] Unfortunately, for the types of scenarios discussed here, which involve unsecured creditors with unliquidated claims, the court will rarely approve a settlement proposition unless the unsecured creditor provides "new value" to the estate.[55] If a proposed settlement receives consideration, however, the court applies a "fair and reasonable test" and determines whether the settlement is in the best interests of the estate.[56]

The steps necessary to effectuate a settlement require first filing a motion with the court and giving all creditors notice of the settlement's terms and conditions.[57] The debtor's creditors then have a right to object to the settlement proposal.[58] If an objection is filed, a hearing on the merits is required.[59] Thus, the movant requesting a settlement in bankruptcy ends up negotiating with the debtor, all the debtor's creditors, the trustee, and the court.

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50 Id. at 799-80 (citations omitted).

51 *See* H. Miles Cohn, *Protecting Secured Creditors Against the Costs of Delay in Bankruptcy: Timbers of Inwood Forest and Its Aftermath*, 6 BANKR. DEV. J. 147, 155 (1989).

52 See Hon. James A. Goodman et. al., *What Constitutes Success in Chapter 11? A Roundtable Discussion*, 2 AM. BANKR. INST. L. REV. 229, 252 (1994).

53 11 U.S.C. § 362(e) (2004).

54 FED. R. BANKR. P. 9019 (2004).

55 11 U.S.C. § 547(c) (2004).

56 *In re Drexel Burnham Lambert Group*, 995 F.2d 1138, 1142 (2d Cir. 1993); *Bostick Foundry Co. v. Lindberg, Div. of Sola Basic Industries, Inc*., 797 F.2d 280, 284 (6th Cir. 1986); *In re Equity Funding Corp. etc*., 603 F.2d 1353, 1363 (9th Cir. 1979); *In re Sapphire S.S. Lines, Inc*., 509 F.2d 1242, 1243 (2d Cir. 1975).

57 FED. R. BANKR. P. 2002(a)(3) (2004).

58 FED. R. BANKR. P 9019 (2004).

59 FED. R. BANKR. P 9019 (2004).

D. Executory Contracts

Another potential hurdle facing attorneys and their non-debtor clients involves executory contracts. The Bankruptcy Code requires the trustee or debtor, depending on the Chapter filed, to accept or reject all the debtor's existing executory contracts --- contracts in which neither party has fully performed.[60] Thus, if a client has entered into a contract with a party that files for bankruptcy, the contract's future could be drastically altered post-petition, and attorneys should be aware of the potential consequences.

For instance, when the debtor chooses assumption, the contract continues in force and both parties comply with its original terms.[61] Additionally, the debtor must cure any amount owing under the contract, which would include pre-petition amounts.[62] Conversely, rejection means that the bankruptcy estate will not render further performance on the contract; thus, the contract falls into the general category of pre-petition obligations that eventually receive a discharge.[63] The option that ultimately applies to the creditor's contract determines whether or not the creditor will recover performance – through the assumption of the contract – or recover damages for breach – due to rejection. If the debtor rejects the contract, a breach occurs, and the claim falls into the estate's unsecured claims pool.[64]

Procedurally, the decision to reject or assume must occur within 60 days of a Chapter 7 bankruptcy filing.[65] For other bankruptcy filings, the debtor does not have to reject or assume until the bankruptcy plan's confirmation hearing.[66] In rare circumstances, if hardship or irreparable harm to the creditor can be demonstrated, the creditor's attorney can file a motion with the court, directing the debtor to assume or reject the contract earlier.[67] Regardless of the debtor's decision to reject or assume, like most actions in bankruptcy, court approval is necessary. And, the court's approval generally turns on the business judgment rule (due care and good faith decision) so the debtor's decision receives a high degree of deference.[68]

II. THE DEFENDANT FILES FOR BANKRUPTCY AFTER THE CLIENT FILES SUIT

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60 11 U.S.C. § 365(a) (2004).

61 Shalom L. Kohn, *Recoupment Re-Examined* 73 AM. BANKR. L.J. 353, 373 (1999).

62 11 U.S.C. § 365(a) (2004).

63 *Id*.

64 *The Use of Bankruptcy Proceedings to Modify Bargaining Agreement Obligations in the United States,* 50 MOD. L. REV. 855, 861 (1987).

65 11 U.S.C. § 365(d)(1) (2004).

66 11 U.S.C. § 365(d)(2) (2004).

67 *In re Shalom Hospitality, Inc*., 2002 Bankr. LEXIS 541, 3-4* (Bankr. N.D. Iowa 2002); *In re New Almacs, Inc.*, 196 B.R. 244, 250 (Bankr. N.D.N.Y. 1996); *In re Monroe Well Serv., Inc*., 83 B.R. 317, 323 (Bankr. E.D. Pa. 1988).

68 *In re O.P.M. Leasing Services, Inc.*, 23 B.R. 104, 118 (Bankr. S.D.N.Y. 1982).

The next scenario discussed involves a situation where a client has filed suit, litigation ensues, and the defendant files for bankruptcy. Many litigators believe bankruptcy signals the end of their client's case. But as previous outlined, the situation's direness can be mitigated by taking steps to help protect and preserve the client's claim.

Generally speaking, a bankruptcy filing affects an on-going lawsuit in much the same way a bankruptcy filing affects a potential lawsuit. As previously discussed, all actions concerning the debtor, including present lawsuits, fall victim to the automatic stay immediately upon the commencement of a bankruptcy proceeding; therefore, without relief from the bankruptcy court, existing litigation cannot continue. But the automatic stay only applies to lawsuits in which the debtor serves as the defendant. Thus, a bankruptcy filing does not prevent an action brought by the debtor (as the plaintiff) against a third party. In fact, the debtor's claim constitutes an asset to the bankruptcy estate, particularly in a Chapter 7 case, where a debtor's lawsuit against a third party may be the estate's *only* asset. Even so, a defendant involved in a pending suit brought by the debtor cannot file a counter-claim against the debtor without court approval because the automatic stay protects the debtor under such circumstances.[69]

As earlier noted, a creditor can continue a suit against a non-debtor co-defendant, regardless of joint and several liability issues, unless the bankruptcy court issues a temporary injunction under Section 105 (a) for the benefit of the estate.[70] Creditors can pursue claims against co-debtors, subsidiaries, sureties, guarantors, directors, officers, or partners. In practice, the creditor's attorney should file a motion to sever the bankrupt defendant in order to continue the case against the other party without offending the automatic stay. Creditors should be leery, though, of pitfalls involving the debtor's property. If a suit against a third-party non-debtor involves the debtor's property, the automatic stay applies, freezing the action.[71] The automatic stay prevents any cross-claims filed against the debtor as well.[72]

In the case of an appeal, if the debtor served as the original defendant, the action is stayed no matter who filed the appeal.[73] But, where the debtor was the original plaintiff, the automatic stay does not apply and the appeal may proceed irrespective of the appealing party.[74] The law is relatively uniform on this point[75]:

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69 *Action Drug Co., Inc. v. Overnite Transport Co*., 724 F.Supp. 269, 278 (D. Del. 1989) (counterclaim against debtor stayed).

70 *See Robbins, supra*, n.34.

71 11 U.S.C. § 362(a)(2-5) (2004).

72 *Sansone v. Walsworth*, 99 B.R. 981, 984 (Bankr. C.D.Cal. 1989) (cross-complaint against debtor stayed).

73 *Assoc. of St. Croix condominium Owners v. St. Croix Hotel Corp*., 682 F.2d 446, 449 (3d Cir. 1982).

74 *Id*.

75 *Nielsen v. Price*, 17 F.3d 1276, 1277 n.2 (10th Cir. 1994); *Farley v. Henson*, 2 F.3d 273, 275 (8th Cir. 1993); *Borman v. Raymark, Inc*., 946 F.2d 1031, 1035 (3d Cir. 1991*); Ingersoll-Rand Fin. Corp. v. Miller Mining Co.*, 817 F.2d 1424, 1426 (9th Cir. 1987*); Freeman v. Commissioner*, 799 F.2d 1091, 1092-93 (5th Cir. 1986); *Teachers Ins. & Annuity Ass'n of Am. V. Butler*, 803 F.2d 61, 65 (2d Cir. 1986).

> [S]ection 362 should be read to stay all appeals in proceedings that were originally brought against the debtor regardless of whether the debtor is the appellant or appellee. Thus, whether a case is subjected to the automatic stay must be determined at its inception. That determination should not change depending on the particular stage of the litigation at which the filing of the petition in bankruptcy occurs.[76]

III. CLAIM ARISES POST-PETITION . . . OR DOES IT?

The third, and last, scenario to be covered, involves a case where a claim against the debtor arises post-petition or after the debtor has filed bankruptcy. While technically not prevented by the automatic stay, attorneys should proceed with extreme caution in bringing a client's claim against a debtor in bankruptcy. The act of filing suit against a debtor in bankruptcy becomes willful and wanton if the attorney wrongly analyzes when the claim arose. In other words, the filing could violate the automatic stay, and hence subject the attorney and the client to actual damages, costs of court, attorneys' fees and possible punitive damages, if the court finds that the claim arose pre-petition.[77] On the other hand, if the claim constitutes a valid post-petition claim, it is classified as a claim of administration in the bankruptcy court, which provides a much better chance of actual recovery.

A. Post-petition vs. Pre-petition:

Two prominent theories exist for determining when a claim arose: the accrual theory and the conduct theory,. The accrual theory holds that the claim arises when damages were sustained.[78] The accrual theory does not take into account the actions giving rise to the damage; hence, if damages arise after the bankruptcy filing, the claim does not relate back to the actions giving rise to the damages regardless of whether those actions occurred pre-bankruptcy.[79] Conversely, the conduct theory, most commonly applied by bankruptcy courts (including the Fifth Circuit and Texas courts), holds that the claim arises on the date that conduct giving rise to the claim occurred. [80] Thus, if damages manifest after bankruptcy, but the actions giving rise to the damages occurred pre-bankruptcy, the claim will relate back to the actions, classifying the claim as pre-petition and subjecting it to the automatic stay.[81]

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76 *St. Croix*, 682 F.2d at 449.

77 11 U.S.C. § 362(h) (2004); *see also Tel-A-Communications Consultants, Inc. v. Auto-Use*, 50 B.R.250, 253-54 (B.C.D.C. Conn. 1985).

78 J. Maxwell Tucker, *The Clash of Successor Liability Principles, Reorganization Law, and the Just Demand That Relief Be Afforded Unknown and Unknowable Claimants*, 12 BANKR. DEV. J. 1, 57-58 (1995); *see also Harig v. Johns-Manville Corp*. 394 A.2d 299, 303 (Md. 1978) (citing *Ayers v. Morgan*, 154 A.2d 788, 792 (Pa. 1959)).

79 *Id*.

80 *Yaquinto v. Sergerstrom*, 247 F.3d 218, 224 (5th Cir. 2001); *Cadleway Props., Inc. v. Andrews*, 239 F.3d 708, 710 (5th Cir. 2001).

81 *Id*. at 44-45; *see also In re Johns-Mansville Corp*., 57 B.R. 680, 690 (Bankr. S.D.N.Y. 1986); *Waterman Steamship Corp. v. Aguiar,* 141 B.R. 552 (Bankr. S.D.N.Y. 1992), *vacated on other grounds*, 157 B.R. 220 (S.D.N.Y. 1993).

B. In Practice

Commonly, if a court can find a way to classify a claim pre-petition, it will.[82] Therefore, attorneys must use caution in calculating when a claim arose to avoid violating the automatic stay. For similar reasons, attorneys should take care not to wait until the conclusion of a bankruptcy proceeding to file a claim against a debtor. If the court applies the conduct theory and determines that a claim arose pre-petition, a good chance exists that the court discharged the claim with the bankruptcy, and if the attorney never filed a proof of claim, the claim is forever lost.

Furthermore, attorneys representing a company recently out of bankruptcy should always perform a pre-petition/post-petition analysis on new claims brought against the client. By establishing that the claim is based on pre-bankruptcy conduct, the claim will probably be dismissed as a pre-petition obligation.

In either case, the bottom line for attorneys in this situation: always ask the bankruptcy court. The court will alert the attorney to the necessity of obtaining permission. And the consequences for not asking (i.e., punitive damages, discharge and malpractice) can be severe.

IV. CONCLUSION

While never welcomed, bankruptcy filings do not necessarily signal the apocalypse. Attorneys need to be aware of the pitfalls and consequences related to a bankruptcy proceeding but should also be familiar with the basic terminology and process. Armed with knowledge of the dreaded bankruptcy monster, an attorney stands a good chance of correctly following the necessary steps and preserving a client's claim.

[82] *Watson v. Parker*, 313 F.3d 1267, 1269 (10th Cir. 2002) (adopting the majority position as in tune with the bankruptcy code, which contemplates all actions related to debtor's estate heard in the bankruptcy court regardless of remoteness.)