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The Bankrupt Defendant and Article 16 Rights

When a defendant declares bankruptcy after a plaintiff has filed a lawsuit, litigation against that defendant is automatically stayed pending resolution of the bankruptcy proceeding. See 11 USC §362(a).

The plaintiff must wait until the bankrupt defendant navigates through the bankruptcy proceedings before continuing to prosecute the claim against that defendant. Alternatively, the plaintiff may make an application in Bankruptcy Court for the stay to be lifted, but must show "cause." See 11 USC §362(d).

Whether the bankrupt party is insured or not is just one factor the Bankruptcy Court considers when deciding whether to lift the stay. The existence of insurance alone (so the bankrupt's estate is not actually in danger of being diminished in the event of an adverse verdict) is not sufficient in and of itself to warrant lifting the stay.¹

Except under certain limited circumstances, the automatic stay provisions of the federal bankruptcy laws do not extend to the nonbankrupt codefendants, so the action can proceed against them, with the action against the bankrupt defendant being severed.²

The question then arises as to whether the remaining defendants may invoke the benefit of CPLR Article 16, which limits a defendant's exposure at trial for noneconomic damages to its proportionate share of fault among all defendants, if that defendant is found to be less than 50 percent culpable in causing the injury. If Article 16 is not applied, a defendant could be responsible for the plaintiff's entire noneconomic loss, even if such defendant had a minimal role in causing the injury.

The relative fault of nonparty tortfeasors may be



considered at trial as well, unless the plaintiff can demonstrate that he or she is unable, with due diligence, to obtain jurisdiction over the nonparty tortfeasor, in which case Article 16 will not apply.³

Jurisdiction Over Bankrupt Defendant

The issue, then, is whether the automatic stay of the action against the bankrupt defendant, whom the plaintiff is now stayed from pursuing, precludes the plaintiff from obtaining jurisdiction over that defendant within the meaning of Article 16, thereby falling into the exception codified in CPLR §1601(1).

Initially, New York State trial courts, the U.S. Court of Appeals for the Second Circuit and the U.S. District Courts for the Southern and Eastern Districts of New York had held that bankrupt parties are to be excluded from consideration for the purposes of apportioning liability among defendants pursuant to CPLR Article 16.⁴ The rationale for these decisions was primarily based upon the construction of "jurisdiction" in CPLR §1601(1): Because the plaintiffs were precluded from continuing an action against the bankrupt defendants, the plaintiffs could not obtain, from a practical standpoint, "effective jurisdiction" over the bankrupt tortfeasors; accordingly, these courts found that the §1601(1) exception applied.

The 'Kharmah' Case

A New York appellate court did not formally consider this issue until 2001. In *Kharmah v. Metropolitan Chiropractic Center*, 288 AD2d 94, 733 NYS2d 165 (1st Dept. 2001), the plaintiff brought a medical malpractice action against a chiropractic clinic, a chiropractor, a hospital and three physicians. After discovery was complete and the case was scheduled for trial, the chiropractor defendants filed for bankruptcy. Plaintiff moved for an order severing the action against the bankrupt defendants, thereby permitting him to continue the action against the remaining defendants. The hospital defendants opposed the motion and requested that the trial court preserve defendants' Article 16 rights in the event of a severance, which would permit the relative culpability of the nonparty chiropractor to be considered at trial.

The trial court granted the plaintiff's motion to sever, but denied defendants' request that their Article 16 rights vis-à-vis the bankrupt defendants be preserved. The defendants obtained an emergency stay of the trial and appealed the trial court's decision.

The Appellate Division, First Department, found severance to be appropriate. Recognizing the prejudice to the remaining defendants if they could not invoke Article 16, however, the court noted that "equity" required the defendants to be able to maintain their Article 16 rights. The court held that the culpability of the nonparty bankrupt defendant could be considered at trial, and that the remaining defendants' exposure for noneconomic damages should be limited proportionately to their share of fault. The Appellate Division's decision in *Kharmah* was remarkably brief, and the court did not discuss the effects of this decision or its reasoning. Rather, it relied almost exclusively upon "equity" to rule in defendants' favor.

The scope of the decision in *Kharmah* was expanded by Justice Helen Freedman in *In re: New York City Asbestos Litigation*, 194 Misc2d 214, 750 NYS2d 469 (Sup.Ct., N.Y.Cty.

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2002) (*Asbestos Two*).

In response to motions and cross-motions, which the court interpreted as the parties' seeking a declaratory judgment to determine the applicability of CPLR §1601(1) and to establish whether the relative culpability of the nonparty bankrupt asbestos manufacturers could be considered at trial when determining the culpability of the party-defendants, Justice Freedman framed the issue as the interpretation of the phrase "unable to obtain jurisdiction" in CPLR §1601(1) and its application to a party who filed for bankruptcy, thus triggering the automatic stay. Defendants argued that filing for bankruptcy does not divest the court of jurisdiction over the bankrupt defendant, that §1601(1) did not apply and, accordingly, that the bankrupt's share of fault should be included when calculating the defendants' exposure for noneconomic losses. The plaintiffs contended that because the automatic stay precluded a plaintiff from, in effect, obtaining jurisdiction over the bankrupt tortfeasor ("effective jurisdiction"), the bankrupt tortfeasor's share should be excluded from the calculation.

Justice Freedman cited a number of cases detailing the rationale behind the creation of Article 16, including the inequities of imposing joint and several liability on low-fault, "deep pocket" defendants and the Legislature's specific intent to limit the situations in which exceptions to Article 16 would be permitted. In addition, Justice Freedman noted that "court-made" exceptions to the statute should not be created. Justice Freedman also cited the decision in *Kharmah*, noting that the Appellate Division, First Department, had preserved the non-bankrupts' Article 16 rights.

Drawing an inference based upon *Duffy v. County of Chautauqua*, 225 AD2d 261, 649 NYS3d 297 (4th Dept.), appeal dismissed, 89 NY2d 980, 656 NYS2d 737 (1996), one of the cases cited in, but not discussed in, *Kharmah*, Justice Freedman concluded that the First Department had interpreted the term "jurisdiction" in CPLR §1601(1) as "personal jurisdiction," rather than "subject matter" (i.e., "effective") jurisdiction. Noting that personal jurisdiction is unaffected by a party's bankruptcy filing and the automatic stay which merely suspends other court proceedings outside the bankruptcy proceedings and does not divest the court of jurisdiction over the bankrupt, Justice Freedman held that "jurisdiction" in CPLR §1601(1) means "personal jurisdiction." The court held that the culpability of bankrupt, nonparty tortfeasors could be included when calculating the defendant tortfeasors' exposure for noneconomic losses. The court held that bankruptcy does not necessarily mean that the plaintiff is "unable to obtain jurisdiction" over the bankrupt party, but that §1601(1) would apply if the plaintiff could prove

that he or she with due diligence could not obtain personal jurisdiction over the bankrupt or its estate.

Justice Freedman's decision was affirmed by the Appellate Division, First Department, in another remarkably short decision. *In re: New York City Asbestos Litigation v. AC&S Inc.*, 6 AD3d 352, 775 NYS2d 520 (1st Dept. 2004). The First Department held that a New York State lower court does not lack jurisdiction over a tortfeasor in bankruptcy and that the exception codified in CPLR §1601(1) did not apply. Interestingly, however, the court refused to make a bright-line rule: "The issue of personal jurisdiction over such an entity, under CPLR §1601(1), must be resolved on the facts of each case, and not simply on whether or not the tortfeasor is bankrupt."

This decision established that the plaintiff seeking to invoke the exception codified in CPLR §1601(1) still has the burden of proving that it cannot obtain jurisdiction over a tortfeasor, but

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that the plaintiff could not use a tortfeasor's bankruptcy in and of itself to argue that it could not obtain jurisdiction over the tortfeasor, and thus avoid the consequences of Article 16. Similarly, this decision makes clear that a defendant cannot simply argue that because a potential codefendant tortfeasor is bankrupt, jurisdiction could have been obtained over that defendant, and that Article 16 should therefore necessarily apply.

'Kharmah's' Scope Expanded

It should be noted, however, that unlike *Kharmah*, where the plaintiff had in fact obtained jurisdiction over the defendants before they declared bankruptcy, the *Asbestos 2* court recognized that this decision would apply to nonparties that had already declared bankruptcy when the actions had started. In this sense, *Asbestos 2* and the First Department, in affirming Justice Freedman's decision, actually expanded the scope of the decision in *Kharmah*. One could now argue more persuasively that personal jurisdiction over an already-bankrupt party could not, in fact, be obtained, in contrast to the defendant over whom jurisdiction has already been asserted.

In *Bifaro v. Rockwell Automation*, 269 FSupp2d 143 (WDNY 2003), the district court recognized that *In re: Brooklyn Navy Yard Asbestos Litigation*, 971 F2d 831 (2d Cir. 1992), had been effectively overruled by *Kharmah* and *Asbestos 2*. It applied *Kharmah* and *Asbestos 2* when deciding that the bankrupt defendant in *Bifaro* was to be included in calculating the apportionment of liability for Article 16 purposes because the plaintiff had failed to show it was not able to obtain personal jurisdiction over the bankrupt party. The decision in *Bifaro* solidified the expanded scope of the decision in *Asbestos 2* because the bankrupt party, which had been named and served, but had never answered, was already bankrupt and dissolved when the action was started.

There has been a clear evolution of the law regarding the applicability of Article 16 to bankrupt defendants. These decisions sought to balance plaintiffs' rights to maintain an action, while diminishing potential prejudice to the defendants by preserving the Article 16 benefits.

This result also coincided with the Legislature's intent when it enacted Article 16. However, the decisions in *Asbestos 2* and *Bifaro* go beyond *Kharmah*, as these courts found that §1601(1) applied to entities that were bankrupt when the action started, and not simply entities over whom jurisdiction had already been asserted when they declared bankruptcy. Moreover, defendants received the evidently unintended benefit of being able to present a case against an "empty chair" to maximize the liability of the nonappearing bankrupt parties. This additional extension is explicitly made in *Bifaro*, when the court noted that dismissing the action against the bankrupt party would not prejudice the remaining defendants because the jury would still be entitled to hear evidence pertaining to the bankrupt's conduct in deciding relative culpability for apportionment purposes.

1. See *In re: Bogdanovich*, 292 F3d 104, 110 (2d Cir. 2002); *In re: Godt*, 282 BR 577, 584 (E.D.N.Y. 2002).

2. See *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Oxford Venture Partners, LLC*, 13 AD3d 89, 786 NYS2d 161, 162 (1st Dept. 2004).

3. CPLR §1601(1) states, in relevant part, that "the culpable conduct of any person not a party to the action shall not be considered in determining any equitable share herein if the claimant proves that with due diligence he or she was unable to obtain jurisdiction over such person in said action...."

4. See *In re: Brooklyn Navy Yard Asbestos Litigation*, 971 F2d 831 (2d Cir. 1992), aff *In re: Eastern and Southern Districts Asbestos Litigation*, 772 FSupp 1380 (E. & S.D.N.Y. 1991); *In re: Joint Eastern and Southern Districts Asbestos Litigation*, 798 FSupp. 940 (E.D.N.Y. 1992); *In re: New York City Asbestos Litigation*, 175 Misc.2d 819, 670 N.Y.S.2d 735 (Sup.Ct., N.Y.Cty. 1998) (*Asbestos One*).

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