

A Guide for the Fidelity Insurer to the Bankruptcy Maze¹

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I. Introduction

For many practitioners, company claim representatives and underwriters, bankruptcy law is obscure and unapproachable. The Bankruptcy Code and procedures are foreign to many in the fidelity insurance industry. The fidelity insurer, however, will often find itself a defendant in an action, or party to a claim asserted by a trustee or debtor in possession. The fidelity insurer perennially pursues salvage from individuals who seek shelter from their creditors in the bankruptcy courts. The goal of this article is to provide a basic overview of some of the issues that commonly confront fidelity insurers when dealing with an insured or principal that has sought the protection of the Bankruptcy Code.² At the outset of this project, the author assumed that an overview of the topic would be a fairly easy task even though there are few papers addressing how bankruptcy issues affect fidelity insurers.³ Though this

¹ The author gratefully acknowledges the assistance of Jennifer L. Susnjara, an associate of the law firm Leo & Weber, in preparing this article.

² The Bankruptcy Code will be referred to by section in this article and is found at 11 U.S.C. §§ 101-1532 (2005). Reference will be made to the “Bankruptcy Code” or simply the “Code.”

³ The author is aware of only one such paper, which was an unpublished paper prepared and presented by James A. Black during the 1983 Fidelity & Surety Law Committee Mid-Winter Meeting. *Bankruptcy Reform Act of 1978—Its Effect Upon Fidelity Bond and Other Non-Contract Bond Sureties: The View From the Claim Side* (unpublished paper presented at mid-winter meeting of the Fidelity & Surety Law Committee, Jan. 28, 1983). A number of articles have addressed bankruptcy and insurance issues generally and served as a useful guide for this project. See John Collen, *Bankruptcy and D&O Insurance*, 11 J. BANKR. L. & PRAC. (Jan.-Feb. 2002). An extensive treatment of bankruptcy issues that affect insurers is Michael S. Quinn & Brian S. Martin, *Insurance and Bankruptcy*, 36 TORT & INS. L.J. 1025 (Summer 2001). See also Muzette Hill &

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article was going to consider the issues from the perspective of the fidelity insurer, enough had been written on the topic of insurance and bankruptcy issues generally that this project was not likely to plow new ground. The United States Congress, either fortunately or unfortunately, offered some new ground for plowing with the passing of The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005,⁴ proving again the adage that “no one is safe while Congress is in session.” The provisions of this act relate directly to many provisions of the Bankruptcy Code that had plagued fidelity insurers in their efforts to seek salvage from fidelity bond principals who had filed for bankruptcy relief.

A detailed commentary of The Bankruptcy Abuse Prevention Act is beyond the scope of this commentary and the expertise of the author. Some general observations about this legislation, however, are appropriate for the introduction to this article. This act is the first comprehensive legislation that significantly affects the ability of individuals to obtain a discharge through a Chapter 7 proceeding. Although past legislation relating to the Code was sponsored by creditor groups, secured lenders and other special interests, the tinkering with the Code through the legislative process was, in the past, confined to specific parochial issues affecting the sponsoring groups. One could argue that The Bankruptcy Abuse Prevention Act represents a significant departure in Congress’ dealing with the Code and a definite move away from making the Code debtor-friendly. The effect of this change may be long term and barely perceptible over time, but just as the prevalence of strip search procedures at airports might inhibit travel activity, the harsher treatment under the Code of those individuals who in the past

James B. Green, *Problems Arising Out of the Insured/Insurer’s Bankruptcy*, 539 PLI/Lit 533 (Jan. 1995); Robert J. McKennon, *Insurance Issues in Bankruptcy: An Insurer’s Perspective*, 30 TORT & INS. L.J. 141 (Fall 1994); Harvey R. Miller & George A. Davis, *The Interplay of Insurance Companies and the Bankruptcy Code*, 659 PLI/Comm 247 (May-June 1993).

⁴ The Bankruptcy Abuse Prevention and Consumer Protection Act, Pub. L. No. 109-8, 119 Stat. 23, enacted Apr. 20, 2005, will be referred to in this article as “The Bankruptcy Abuse Prevention Act,” and citations of the new provisions will be to the Bankruptcy Code sections in which these provisions are found.

were willing to assume business risks might in the long term inhibit otherwise desirable business activity that involves some risk. Commentators from the U.S. Trustees Office herald the changes as beneficial and long overdue,⁵ while other commentators have noted that not a single established group of attorneys, including the American Bar Association, judges, law professors and consumer advocates supported the bill.⁶ Some have likened this legislative effort to “killing a mosquito with a shotgun.”⁷ Certainly, the addition of the phrase “consumer protection act” to the name of the legislation arguably renders the title an oxymoron, insofar as the legislation eliminates some key protection for consumers.

For the fidelity insurer, The Bankruptcy Abuse Prevention Act probably hits some of the mosquitoes that plague their recovery efforts in bankruptcy and so may not be an unwelcome shotgun approach. As will be discussed below, the limits placed on homestead exemptions, consecutive filings and the ability of certain individuals to obtain a discharge through a Chapter 7 will likely enhance the prospects for recovery by fidelity insurers. The reason for this is simple: when chasing fidelity bond principals for recovery, out of all creditor groups, fidelity insurers deal with the most abusive bankruptcy cases, generally initiated by debtors who have committed some real wrongdoing and who are intent on using the bankruptcy process to continue their wrongdoing by keeping as much of their assets away from their creditors as possible. Fidelity insurers in this context deal with bankruptcy law at the fringes.

This article will address how the Bankruptcy Code impacts the fidelity insurer under the circumstances the fidelity insurer most commonly finds itself involved with the Bankruptcy Code and bankruptcy process—when the claimant is the debtor and when the fidelity insurer is the creditor. When the claimant is the debtor, the fidelity insurer will want to take whatever steps it can to protect its rights

⁵ Lawrence A. Friedman, *Seize the Opportunity to Improve America’s Bankruptcy System*, 24 AM. BANKR. INST. J. 14 (May 2005).

⁶ Jennifer Emens-Butler, Esq., *Bankruptcy Reform Gather Round Children, Yes, the Sky is Falling*, 31 VT. BUS. J. 26 (Spring 2005).

⁷ Letter from Professors Richard I. Aaron, *et al.*, to Senators Arlen Specter and Patrick Leahy (Feb. 16, 2005), *available at* www.abiworld.org.

and obtain a fair adjudication of the claim. Bankruptcy courts may be more debtor-oriented and less inclined to rule in favor of the fidelity insurer, especially when such a ruling might mean the estate loses a substantial recovery. When the fidelity insurer is the creditor, the bankruptcy court may offer a more welcome forum for fully asserting its rights against the bond principal and assuring that a nondischargeable debt is treated appropriately. In many instances, the bankruptcy court is the best and quickest path for the fidelity insurer to obtain relief from the fidelity bond principal.

II. Types of Bankruptcy Proceedings

A fidelity insurer will typically be involved in three types of bankruptcy proceedings. It is unlikely that a fidelity insurer will face a claim or seek recovery in a case involving a utility, farmer or municipality. In the Orange County bankruptcy, however, fidelity claims were asserted by a municipality debtor,⁸ but in most instances, fidelity insurers will be involved in individual Chapter 7 proceedings, corporate Chapter 7 proceedings, Chapter 11 reorganizations and Chapter 13 individual plans.

A. CHAPTER 7 PROCEEDINGS

The goal of an individual Chapter 7 proceeding is for an individual debtor to obtain a discharge of his or her debts and obtain a fresh start. Only an individual person is entitled to a discharge in a Chapter 7 proceeding. A corporation can only obtain a discharge under section 524 of the Code under the terms of an order confirming a Chapter 11 plan of reorganization. A corporation is not discharged in a Chapter 7 proceeding and simply proceeds to windup its business and dissolve without a formal discharge of its debts.⁹

The assets of an individual or corporation in a Chapter 7 are mustered by a trustee and distributed to creditors in accordance with the priorities established under the Bankruptcy Code.¹⁰ An individual is

⁸ *In re County of Orange*, 183 B.R. 594 (Bankr. C.D. Cal. 1995).

⁹ 11 U.S.C. § 727(a)(1) (2005).

¹⁰ 11 U.S.C. § 726 (2005).

entitled to retain certain property that would be exempt from judgment under state or federal law.¹¹ Secured parties, holding properly perfected security interests in the property of the debtor, are entitled to recover the value of the secured interest in that property and to assert an unsecured claim for any deficiency or to the extent the disposition or value of the secured property does not fully satisfy the claim.¹² Tax and certain wage claims are entitled to payment as priority unsecured claims.¹³

The fidelity insurer is often a creditor in the Chapter 7 proceeding of the fidelity bond principal or third party that caused or contributed to the loss. Often, because the insurer's claim arises out of dishonest or fraudulent conduct on the part of the debtor, the fidelity insurer will also pursue an action against the debtor that the claim is not dischargeable or that the debtor is not entitled to a discharge. The specific grounds for asserting the nondischargeability of a claim are set forth in section 523 of the Bankruptcy Code. The grounds for seeking a denial of a debtor's discharge are set forth in section 727.¹⁴

The culmination of an individual Chapter 7 is a discharge order and the distribution of the debtor's assets in accordance with the priorities of the Code. If the assets are not sufficient to pay the creditors in full, the assets available for distribution are distributed pro rata.¹⁵ If an insurer obtains an order that a particular debt is not dischargeable, it retains the right to continue to recover from the debtor after the discharge order as though the discharge order was never entered. Unlike other creditors, once the debt is ordered nondischargeable, the insurer can continue to garnish wages and seek recovery from the future earnings and property of the debtor.

B. CHAPTER 11 PROCEEDINGS

Chapter 11 proceedings usually relate to the efforts of corporations to reorganize their business through a plan of

¹¹ 11 U.S.C. § 522(b) (2005).

¹² 11 U.S.C. § 506(a) (2005).

¹³ 11 U.S.C. § 507 and § 724 (2005).

¹⁴ 11 U.S.C. § 727 (2005).

¹⁵ 11 U.S.C. § 726(b) (2005).

reorganization.¹⁶ Individuals can also seek to reorganize their debts and obligations through a plan, and because of the changes wrought by The Bankruptcy Abuse Prevention Act, are more likely to use this procedure in the future. The fidelity insurer will find itself involved in a Chapter 11 proceeding of its insured usually in situations where the insured debtor or its representative is asserting a claim against the fidelity policy. Banks, certain other financial institutions and insurance companies do not qualify for Chapter 11 relief because they are subject to either federal or state reorganization proceedings.¹⁷ Bank holding companies and insurer holding companies, however, might be subject to reorganization under the Bankruptcy Code.¹⁸

It is not very often that a fidelity insurer is a creditor in a Chapter 11 proceeding. The circumstances under which a fidelity insurer might include where it is asserting a claim against a debtor for contributing to or causing a loss, or, where the insurer is seeking recovery of premium. It is beyond the scope of this article to discuss the reorganization process in detail. The goal of a plan may be the continued operation of the debtor as a reorganized entity or the liquidation of the debtor's assets through a liquidating trust.¹⁹ There are time limits for the debtor exclusively to file and confirm a plan of reorganization.²⁰ The Bankruptcy Abuse Prevention Act now limits the common practice of the bankruptcy courts to grant the debtor extensions of this exclusivity period. After the exclusive period expires, other creditors and creditor groups can file and sponsor a plan. Section 1129 provides certain terms for the payment of debts under a plan. Tax

¹⁶ 11 U.S.C. §§ 1101-1174 (2005).

¹⁷ 11 U.S.C. § 109(d) (2005).

¹⁸ 11 U.S.C. § 109(d) (2005); *see also* MCorp Fin., Inc. v. Board of Governors Fed. Reserve Sys. of the United States of America, 958 F.2d 615 (5th Cir. 1992) (bank holding company as a Chapter 11 debtor).

¹⁹ 11 U.S.C. §§ 1101-1174; *see also* Robert J. McKennon, *Insurance Issues in Bankruptcy: An Insurer's Perspective*, 30 TORT & INS. L.J. 141, 142 (Fall 1994).

²⁰ 11 U.S.C. § 1121(b) (2005).

claims, for example, must be paid in full or be subject to payment terms with interest not to exceed six years.²¹

A plan places claims into separate classes.²² The classification of claims can be the subject of extensive plan litigation. Section 1129 codifies the common law “absolute priority rule,” which provides that the equity holders of a company cannot retain an interest in the company or its assets without the consent of the other classes of creditors if these creditors have not been paid in full.²³ There is a debate over whether there is a new value exception to the absolute priority rule that permits an equity holder to retain an interest in the debtor if the equity holder adds new value to the creditors through the plan.²⁴ Voting for the plan is done by classes, with each class deemed to have accepted the plan if the holders of the claims representing two thirds of the amount of the claims and one half of the number of the claims of that class vote to accept the plan.²⁵ A plan can be confirmed if only one class accepts, provided the plan meets all the requirements of a “cram down” set forth in section 1129.²⁶

A fidelity insurer would only find itself involved in the plan confirmation process if it is a creditor of the Chapter 11 debtor. It is

²¹ 11 U.S.C. § 1129(a)(9)(c) (2005).

²² 11 U.S.C. § 1122 (2005).

²³ 11 U.S.C. § 1129 (2005).

²⁴ *In re Drimmel*, 135 B.R. 410, 416 (D. Kan. 1991) (noting “the new value issue . . . [where] a court might have been permitted . . . to allow a former equity holder to participate on the strength of future contribution alone was vigorously debated in law reviews”); *see also* *Travelers Ins. Co. v. Bryson Props.*, XVIII (*In re Bryson Properties XVIII*), 961 F.2d 496 (4th Cir. 1992) (reviewing split in cases regarding the new value exception), *cert. denied*, 506 U.S. 866 (1992); *Kham & Nate's Shoes No. 2 v. First Bank of Whiting*, 908 F.2d 1351 (7th Cir. 1990) (questioning strength of the new value exception). A United States Supreme Court decision often cited in support of the proposition that there is a new value exception to the absolute priority rule, which expressly declined to address the issue of the new value exception, is *Bank of America Nat'l Trust and Sav. Assoc. v. 203 North LaSalle St. P'ship*, 526 U.S. 434 (1999).

²⁵ 11 U.S.C. § 1126(c) (2005).

²⁶ 11 U.S.C. § 1129(b) (2005).

more likely the Chapter 11 debtor will be the insured and a claimant on the policy. The Chapter 11 debtor may also desire to assume or to maintain the policy in effect for its operations.

C. CHAPTER 13 PROCEEDINGS

The goal of a Chapter 13 proceeding is for the individual debtor to restructure its debts and payments through a court ordered repayment plan. This chapter applies to individual wage earners who are within the applicable debt limits for this type of relief.²⁷ Under the terms of a Chapter 13 case, the debtor must apply his or her disposable income towards the repayment of debts over a period of usually three years.²⁸

A fidelity insurer is likely to be a creditor in a fidelity bond principal's Chapter 13 plan. This section allows for the debtor to propose for payment over time of even nondischargeable debts.²⁹ In very rare cases, Chapter 13 proceedings are filed immediately after the debtor obtains a Chapter 7 discharge to permit the debtor to pay the nondischargeable debts from the Chapter 7 proceeding over time pursuant to a Chapter 13 plan.³⁰ This strategy has sometimes been called a "Chapter 20," a strategy which, as discussed below, is curtailed by The Bankruptcy Abuse Prevention Act.

III. Procedural Issues in Bankruptcy

There are a number of procedural and jurisdictional issues that will impact the fidelity insurer. If the insurer is engaged in a declaratory action with the debtor, it may want to litigate the matter in the state court as opposed to the bankruptcy court. An insurer will want to make sure that any claim it can assert as a creditor is preserved, that it efficiently adjudicates any claims against the fidelity bond principal and that it preserves all of its rights under the policy.

²⁷ 11 U.S.C. § 109(e) (2005).

²⁸ 11 U.S.C. § 1322(d) (2005).

²⁹ 11 U.S.C. § 1322 (2005).

³⁰ *In re Cushman*, 217 B.R. 470, 475-76 (Bankr. E.D. Va. 1998); *In re Jahnke*, 146 B.R. 830, 833 (Bankr. E.D. Cal. 1992).

A. JURISDICTION OVER DECLARATORY ACTIONS

Bankruptcy court jurisdiction has been the subject of a number of decisions. The grant of jurisdiction under the original Bankruptcy Code in 1978 resulted in the Supreme Court holding that the Code was unconstitutional for allowing bankruptcy judges to hear cases and controversies, which Article III of the Constitution only permits full, duly-appointed district court judges to hear.³¹ Obviously, the drafters of the Code needed to limit the power of the bankruptcy judges to hear matters in order to satisfy the constitutional requirements. The *Marathon Pipe Line* decision spurred the creation of the present jurisdictional framework in Title 28 for hearing cases in the bankruptcy courts.³²

Section 157 of Title 28 recognizes that bankruptcy jurisdiction is divided into “core” and “related to” jurisdiction. The bankruptcy court itself is a division within each district court and “related to” matters are subject to referral to the bankruptcy court by the district court or judge.³³ Core matters are those issues that are plainly within the jurisdiction of the bankruptcy court, such as, allowance or disallowance of claims, the right to a discharge, and the determination of the dischargeability of any particular debt. “Related to” matters are matters the court possesses jurisdiction over that are related to the administration of the debtor’s estate but that are subject to referral.³⁴

A declaratory action brought by a debtor against a fidelity insurer is within the jurisdiction of the bankruptcy court as a “related to” matter.³⁵ Because fidelity policies are first party indemnity policies, the proceeds of which would be payable to an insured debtor, unlike liability

³¹ *Northern Pipeline Constr. Co. v. Marathon Pipe Line Co.*, 458 U.S. 50 (1982).

³² *Id.*; see also 28 U.S.C. § 157 (2005).

³³ 28 U.S.C. § 157(c)(2) (2005).

³⁴ 28 U.S.C. § 157(b)(2) (2005).

³⁵ *In re Pintlar*, 124 F.3d 1310 (9th Cir. 1997) (examining the bankruptcy court’s jurisdiction to hear a declaratory action under a D&O policy; D&O policies in bankruptcy differ slightly from fidelity policies in that D&O policies in bankruptcy offer not only protection to a debtor corporation, but also protection to non-debtor officers and directors).

policies or D&O policies, there is no question that a fidelity policy is property of the insured's bankruptcy estate.³⁶ Whether the debtor is entitled to the proceeds of the policy, therefore, is not a factor in determining what court should hear the dispute. A fidelity insurer can seek to have the reference withdrawn to have a declaratory action heard in the district court, or if an action was pending in the state court before the filing of the petition, request that the bankruptcy court abstain from hearing the matter.³⁷ If there is a pending state action at the time of the filing of the petition, which involves predominant questions or issues of state law, the bankruptcy court may be subject to mandatory abstention.³⁸ The fidelity insurer may have the option to have a declaratory action on a policy heard in a court other than the bankruptcy court.

B. CANCELLATION OR TERMINATION OF A BOND OR POLICY AND THE AUTOMATIC STAY

The automatic stay enjoins virtually all actions of creditors against the debtor and the debtor's property. The automatic stay prohibits an insurer from terminating or canceling a policy or contract of insurance after the filing of the petition without seeking relief from the automatic stay.³⁹ A policy that terminated pre-petition cannot be property of the estate because all of debtor's rights terminated before the start of the bankruptcy case. A policy that expires on its own terms after the filing of the petition will expire post-petition in accordance with its terms.⁴⁰ A policy will not terminate automatically because a debtor fails

³⁶ *Houston v. Edgeworth (In re Edgeworth)*, 993 F.2d 51, 56 (5th Cir. 1993) (“[T]he overriding question when determining whether insurance proceeds are property of the estate is whether the debtor would have a right to receive and keep those proceeds when the insurer paid on a claim.”).

³⁷ 28 U.S.C. § 1334(c)(2) (2005).

³⁸ 28 U.S.C. § 1334(c)(2) (2005); 28 U.S.C. § 157 (2005).

³⁹ 11 U.S.C. § 362 (2005).

⁴⁰ 11 U.S.C.A. § 362(a)(1) (2005); *see also Hazen First State Bank v. Speight*, 888 F.2d 574, 576 (8th Cir. 1989) (holding the automatic stay provided for by section 362(a) does not enlarge the rights of individuals under a contract nor does it toll the running of time under a contract, and will not prevent the automatic termination of a contract by its own terms).

to pay the premium. The insurer must move to lift the automatic stay.⁴¹ Moreover, any obligation that the debtor has on the policy, to pay a premium or to give notice of discovery of a loss, may be extended by operation of section 108 of the Bankruptcy Code by 60 days.⁴² The time for filing suit on the policy may be expanded by as much as two years by operation of section 108 of the Code.⁴³

A fidelity insurer that wants to terminate a policy must determine whether it needs to promptly lift the automatic stay. In evaluating its exposure and whether the policy is subject to immediate termination, the insurer must keep in mind that the debtor may have additional time to assert a claim or tender a required premium.

C. THE FIDELITY POLICY AS AN EXECUTORY CONTRACT

Section 365(a) provides that a debtor may assume or reject an executory contract. Assumption of a contract is the means by which a debtor brings the contract into the estate. Once a contract is assumed all of the burdens of the contract are obligations of the estate and become administrative expense claims.⁴⁴ By rejecting a contract, the debtor essentially sheds the burdens of the contract and forgoes the benefits of the contract. The rejection of the contract is deemed a breach of the contract as of the date of the petition which results in an unsecured claim in favor of the non-debtor party to the contract.⁴⁵

An insurance policy is often treated as an executory contract, which means a debtor may have the option to assume that contract.⁴⁶ By assuming the policy, the debtor can at least keep coverage in place until the policy expires by its own terms. But to assume a contract over the objection of an insurer, the debtor must show that it can cure all

⁴¹ 11 U.S.C. § 362(d) (2005); *In re Lissig Constr. Inc.*, 67 B.R. 436, 437 (Bankr. E.D. Pa. 1986).

⁴² 11 U.S.C. § 108(b) (2005).

⁴³ 11 U.S.C. § 108(a) (2005).

⁴⁴ *In re Pearson*, 90 B.R. 638, 642 (Bankr. D.N.J. 1988).

⁴⁵ 11 U.S.C. § 365(g) (2005); *In re El Paso Refinery, L.P.*, 220 B.R. 37, 45 (Bankr. W.D. Tex. 1998).

⁴⁶ *In re A.H. Robins Co., Inc.*, 68 B.R. 705, 707 (Bankr. E.D. Va. 1986).

preexisting defaults and provide adequate assurance of future performance.⁴⁷ If there is a substantial question about the debtor's ability to continue to pay premiums or its ability to remain intact operationally for the term of the policy, the fidelity insurer may have grounds to object to the assumption of the policy by the debtor.

The question of whether a debtor will assume a contract of insurance is only going to arise in a Chapter 11 proceeding. In a Chapter 7 proceeding, where the insured debtor is liquidating, there is no reason to keep a fidelity policy for a company that is ceasing operations. Although a trustee in a Chapter 7 proceeding must assume a contract within 60 days of the date of the order of relief or it is deemed rejected, there is no such restriction in the Code in a Chapter 11 proceeding; the Code allows for assumption or rejection of executory contract at any time up to the time of confirmation of a plan.⁴⁸ If the debtor delays in making this election, a party to a contract or policy can move for the court to set a date for the assumption or rejection of the policy.⁴⁹

D. SOME TIME LIMITS THAT MIGHT AFFECT THE FIDELITY INSURER'S CLAIM

The procedural issues addressed up to this point contemplate the insured as the debtor. The issues addressed in this section and the remaining procedural issues contemplate the fidelity insurer as a creditor of the estate of the fidelity bond principal or other third party that contributed to the loss.

As noted above, the fidelity law practitioner practices bankruptcy law at the fringes. What fidelity claims representatives and attorneys find are the normal issues in their bankruptcy experience, most ordinary bankruptcy practitioners regard as once-in-a-career-type cases. Fidelity insurers are frequently surprised by the pendency of bankruptcy proceedings of which they were not aware, initiated by the fidelity bond principal without providing notice to the insurer, and sometimes only discovered by the insurer after a discharge order was entered by the

⁴⁷ 11 U.S.C. § 365(b)(1) (2005).

⁴⁸ 11 U.S.C. § 365(d)(2) (2005); 11 U.S.C. § 1123(b)(2) (2005).

⁴⁹ 11 U.S.C. § 365(d)(2) (2005).

bankruptcy court. In the author's experience, a common first step in representing a fidelity insurer in a bankruptcy proceeding is the motion to reopen the case and vacate the discharge order. These motions are often granted upon a showing that the insurer had no actual notice of the bankruptcy proceeding.⁵⁰ The standard is actual notice, as opposed to formal notice, through inclusion on the service list in the case.⁵¹ In the era of electronic docket and availability of court documents online, as well as the ability to conduct searches of case filings, the lack of actual notice may become increasingly harder to establish.

Individuals who have committed dishonest and fraudulent acts may seek bankruptcy relief in the hope that the holders of any nondischargeable claims against them may not diligently protect their rights. Bankruptcy is often a trap for the unwary creditor and an escape hatch for the ambitious debtor. Time limits can be harshly applied to limit creditors' rights and permit the debtor relief from its debts.⁵²

The Bankruptcy Code sets many of the deadlines using the first meeting of creditors as a base date.⁵³ The first meeting of creditors gives the creditors an opportunity to assess the debtor's case and determine their position as creditors in the case. As a general rule, the schedules of assets and liabilities and the list of exempt property is filed by the debtor on or before the first meeting of creditors. The first deadline after the first meeting of creditors is the 30-day time frame for filing objections to

⁵⁰ *In re Ellis*, 112 B.R. 182, 183 (Bankr. S.D. Tex. 1989) (citing *Matter of Adams*, 734 F.2d 1094, 1098 (5th Cir. 1984)).

⁵¹ *In re Ellis*, 112 B.R. at 183.

⁵² Honorable Margaret Dee McGarity, *The Basics: Debtor's Duties, Exemptions, Discharge and Dischargeability*, 796 PLI/Comm 181, 183 (Nov. Dec. 1999).

⁵³ The first meeting of creditors, also referred to as the section 341 meeting, is generally held to permit the trustee and creditors an opportunity to review the debtor's schedules of assets and liabilities and to question the debtor's representative to make an initial assessment of the case. In a Chapter 7 or Chapter 11, the trustee or U.S. Trustee's office schedules this meeting within 20 to 40 days of the order of relief. A Chapter 13 first meeting of creditors is to be scheduled within 20 to 50 days after the entry of the order of relief. See FED. R. BANKR. P. 2003 (2003).

exemptions claimed by the debtor.⁵⁴ If the debtor amends the schedule, the time for filing an objection is extended thirty days after the date of such amendment. The failure to file an objection can be deemed a waiver of any right to assert the property claimed as exempt should be part of the debtor's estate.⁵⁵

An adversary complaint objecting to a debtor's discharge in a Chapter 7 proceeding must be filed no later than sixty days after the first date set for the first meeting of creditors.⁵⁶ In a Chapter 11 proceeding, the complaint shall be filed no later than the first date set for the hearing on the confirmation of a plan.⁵⁷ With respect to a Chapter 13 debtor, there is no procedure for objecting to the discharge a debtor will receive upon making payments under the terms of the plan. A creditor's remedy is to object to the terms of the plan or to object that the plan was not proposed in good faith.⁵⁸

Complaints for finding a particular debt is not dischargeable must be filed in a Chapter 7 and Chapter 11 proceeding within sixty days of the date of the first meeting of creditors.⁵⁹ In a Chapter 13 proceeding, the time for bringing suit to determine the dischargeability of a debt will be set by the bankruptcy court, which must provide at least thirty days notice of that deadline to the creditors.⁶⁰

A creditor may have grounds under section 727 to assert that a debtor be denied a discharge as well as grounds under section 523 that the particular debt owed by the debtor to the creditor is not subject to discharge. The fidelity insurer may need to decide whether to assert

⁵⁴ FED. R. BANKR. P. 4003(b) (2003).

⁵⁵ Taylor v. Freeland & Kronz, 503 U.S. 638 (1992); *see also In re Kazi*, 125 B.R. 981, (Bankr. S.D. Ill. 1991), *aff'd*, 985 F.2d 318 (7th Cir. 1993).

⁵⁶ FED. R. BANKR. P. 4004(a) (2003).

⁵⁷ FED. R. BANKR. P. 4004(a) (2003).

⁵⁸ There is no mechanism in the Code or the Rules for a creditor to object to a discharge. There is a procedure for revoking a Chapter 13 discharge, but only if that discharge was procured through fraud and the party seeking revocation did not know of the fraud until after the discharge was granted. 11 U.S.C. § 1330 (2005).

⁵⁹ FED. R. BANKR. P. 4007(c) (2003).

⁶⁰ FED. R. BANKR. P. 4007(d) (2003).

both theories against a debtor. If a debtor is fully denied a discharge, then it remains subject to the claims of all of its creditors. If a particular debt is determined to be nondischargeable, the creditor holding the claim may have a better chance of future recovery from a debtor whose other obligations have been discharged.

The time for filing a proof of claim as a creditor in a Chapter 7 and Chapter 13 proceeding is generally ninety days after the date of the first meeting of creditors.⁶¹ In a Chapter 11 proceeding, the court sets the time for filing proofs of claim.⁶²

An insurer may be asserting a claim as the subrogee of the insured. If a subrogee has failed to take action within the time frames set by the Code and the Rules, then the insurer will have lost its right to pursue whatever claim or action its insured held. Where the insured or obligee obtains an extension of time from the bankruptcy court, at least one recent decision holds that the party asserting the claim against the estate as a subrogee is entitled to the benefit of that extension of time.⁶³

It is imperative that the fidelity insurer be aware of the time frames for asserting claims and actions against the debtor. Those debtors who face fidelity insurers as creditors hope that a lack of diligence on the part of their creditors will take them off the hook.

E. COMPLAINTS OBJECTING TO A DISCHARGE AND THE DISCHARGEABILITY OF DEBTS

Fidelity insurers probably file more complaints to determine whether a debtor is entitled to a discharge or whether a particular debt is not dischargeable than any other discrete group of creditors. If there are statistics for this type of action, banks probably lead in the overall

⁶¹ FED. R. BANKR. P. 3002(c) (2003).

⁶² FED. R. BANKR. P. 3003(c)(3) (2003).

⁶³ *Travelers Cas. & Sur. Co. of Am. v. Haught*, No. 04 C 8210, 2005 WL 643345, at *1 (N.D. Ill. Mar. 16, 2005) (surety's objection to the dischargeability of its claim was timely filed where the objection was filed within the time of the beneficiary's extension of time to object and the surety was subrogated to the rights of the beneficiary).

number of such complaints filed. Fidelity insurers probably file the greatest percentage of such complaints relative to the number of bankruptcy cases in which they are active as creditors. This follows from the nature of the coverage and the parties fidelity insurers chase through the bankruptcy maze—folks who may have or did commit fraudulent and dishonest acts.

An objection to a debtor's discharge must be brought as an adversary complaint.⁶⁴ The specific grounds for objecting to a discharge are enumerated in section 727, and include: transferring, removing and destroying property of the estate with the intent to hinder or delay a trustee or creditor charged with custody of the property; concealing or destroying records of the debtor; and making false statements in connection with the case.⁶⁵ An objection to discharge is a core proceeding and will be heard in the bankruptcy court. There is some disagreement among the courts over the burden of proof to be applied in an objection to discharge action. Some courts apply the preponderance of evidence standard, while others require clear and convincing evidence that the debtor committed acts supporting the denial of a discharge.⁶⁶

A complaint to determine the nondischargeability of a particular debt is also a core proceeding that must be asserted through an adversary complaint.⁶⁷ The burden of proof generally applicable to such actions is proof of the elements by a preponderance of evidence.⁶⁸ If in a prior state court action there has been a finding of fraud or other misconduct

⁶⁴ FED. R. BANKR. P. 7001(4) (2003).

⁶⁵ 11 U.S.C. § 727(d) (2005).

⁶⁶ *Grogan v. Garner*, 498 U.S. 279 (1991) (holding that preponderance of the evidence standard, rather than clear and convincing evidence standard, applies to all exceptions from dischargeability of debts, including nondischargeability for fraud provision); *In re Sanders*, 128 B.R. 963 (Bankr. W.D. La. Feb. 20, 1991) (applying a clear and convincing standard to § 727(a)(4) cases rather than the preponderance of the evidence standard applied by the Supreme Court in *Grogan*); *Holmes Limestone Co. v. U.S.*, 946 F. Supp. 1310 (N.D. Ohio Nov. 13, 1996) (following the Sixth Circuit precedent after *Grogan* in applying a clear and convincing standard in cases involving fraud).

⁶⁷ 28 U.S.C. § 157(b)(2)(I) (2005).

⁶⁸ *Grogan v. Garner*, 498 U.S. at 284 (applying preponderance of the evidence standard to all exceptions from dischargeability of debt).

giving rise to a grounds for finding the debt is nondischargeable, collateral estoppel may apply in the bankruptcy action to decide if the debt is not dischargeable.⁶⁹ The bankruptcy courts will carefully scrutinize the nature of the state court or other action and the record in the case to decide whether collateral estoppel should apply.⁷⁰

The fidelity insurer may encounter difficult proof issues where it settles the underlying claim with the insured and then pursues a nondischargeability action against the employee in the bankruptcy case. Certainly an adjudication against the fidelity insurer based on a finding that the employee debtor committed dishonest and fraudulent acts within the meaning of the coverages commonly in use would support a finding that the debt of the employee is not subject to discharge.⁷¹ Acts done with the manifest intent to cause a loss to the insured would plainly fall within some of the acts enumerated in section 523 giving rise to nondischargeable debts, such as, fraud, embezzlement, larceny, and willful and malicious injury by the debtor.⁷² When a claim is settled, the debtor can litigate the specific grounds for finding a debt is not subject to discharge.

⁶⁹ *Id.*

⁷⁰ *In re* Supple, 14 B.R. 898, 904 (Bankr. D. Conn. 1981) (“[A] bankruptcy court cannot give collateral estoppel effect to a prior state court adjudication if the issue before the bankruptcy court differs from the issue which was before the state court. The standards employed by the state court in reaching its decision must comport with federal standards. To insure such identity of standards, a bankruptcy court must scrutinize the entire record of the state court proceedings.”).

⁷¹ A canvas of reported decisions suggests that fidelity insurers are largely successful in establishing the employee debts arising out of fidelity losses are not dischargeable. See *In re* Graziano, 35 B.R. 589 (Bankr. E.D.N.Y. 1983) (also holding creditor failure to file proof of claim does not bar action to determine dischargeability); *In re* Toledo Blade Co., 33 B.R. 588 (Bankr. N.D. Ohio 1983) (embezzlement); *In re* Lilly, 1 B.R. 773 (Bankr. D.Md. 1980) (breach of fiduciary duty).

⁷² 11 U.S.C. § 523(a)(4) and (6). An adjudication of liability under the pre-1978 coverages that did not include the manifest intent provision may not conclusively establish that the employee committed an act giving rise to a nondischargeable debt within the meaning of section 523(a).

F. PREFERENCE LITIGATION

A debtor or a trustee may recover preferential transfers from creditors.⁷³ The purpose of the preference provision of the Bankruptcy Code, as the name implies, is to prevent a debtor on the eve of bankruptcy from transferring property to certain preferred creditors. Another goal of the preference provision is to prevent the creditors from engaging in a frenzied fight to carve up a debtor on the brink of insolvency.

A trustee's preference claim can be one of the cruelest surprises for a creditor, especially a creditor who through its diligence finally obtains a recovery from the debtor, only to be compelled to return this recovery to the estate. A fidelity insurer could find itself a defendant in a preference action. If the debtor is an insured, its trustee might seek recovery of premiums paid to the insurer. If the debtor is the employee who caused a loss, the preference action might seek to recover funds paid or recovered by the insurer in a settlement or recovered as a result of the execution of a judgment.

A preferential transfer is the transfer of property of the debtor to a creditor for or on account of an antecedent debt, made while the debtor is insolvent, within 90 days of the filing of the petition, which allows the creditor to recover more than it would have if the transfer had not been made and the debtor filed for Chapter 7 relief.⁷⁴ If transfer is made to an insider of the debtor as defined in section 101 of the Code, then the preference can be recovered if the transfer was made within one year of the date of the filing of the petition.⁷⁵ A fidelity insurer will never be an insider of its insured or the fidelity bond principal, the likely debtors for the insurer's involvement in the bankruptcy process, so the 90-day reach back period for avoidance of a preference would usually apply.

There are statutory exceptions to a preference claim, such as transfers in the ordinary course of business or the contemporaneous

⁷³ 11 U.S.C. § 547 (2005).

⁷⁴ 11 U.S.C. § 547(b) (2005).

⁷⁵ 11 U.S.C. § 547(b)(4)(B) (2005).

exchange for value.⁷⁶ In a preference action, the debtor or trustee bears the burden of proving all the elements of the preference. If an exception is asserted, the creditor bears the burden of proving that the exception applies.⁷⁷ The outcome of preference litigation often depends on the ability of the creditor to meet the burden of proving that an exception applies.

An insurer or agent that collects premiums in the ordinary course of business or at the time of renewal of a policy would not be subject to preference liability. Such a payment is not an antecedent debt, and falls within the exceptions of payment in the ordinary course of business, or, in the case of a renewal premium paid upon renewal of the policy, a contemporaneous exchange for value.⁷⁸ The insurer or agent risks preference liability where the account is delinquent in its payments and arranges for a lump sum payment or payments pursuant to some special payment arrangement within 90 days of the filing for relief.

A settlement payment from a fidelity bond principal made within 90 days of that individual's seeking relief under the Code almost always runs the risk of avoidance as a preference. A recovery on a judgment can similarly be avoided by the trustee. The fact that a debt is nondischargeable does not except payments on that debt from the preference provision. Even recoveries for criminal restitution have been avoided as preferential.⁷⁹

The timing of a preference action can also surprise creditors. Such actions can be brought at any time after the later of: a) two years of the entry of the order of relief, or b) one year after the appointment of a trustee if that appointment is within the two-year period.⁸⁰ If a trustee is appointed at the very end of the two-year period after the conversion of a Chapter 11 case to a Chapter 7 proceeding, a timely preference

⁷⁶ 11 U.S.C. § 547(c)(2)(A) (2005).

⁷⁷ 11 U.S.C. § 547(g) (2005).

⁷⁸ *In re Service Bolt & Nut Co.*, 97 B.R. 892 (Bankr. N.D. Ohio 1989); *In re AOV Industries, Inc.*, 85 B.R. 183 (Bankr. D.C. 1988).

⁷⁹ See *In re Bova*, 272 B.R. 49 (Bankr. D.N.H. 2002) (where trustee avoided lien securing judgment for criminal restitution).

⁸⁰ 11 U.S.C. § 546(a) (2005).

action could be filed almost three years after the filing for relief. It is common that one of the last acts of a trustee in winding up an estate is to file and prosecute the preference and other avoidance actions. Creditors often face preference actions long after they have forgotten receiving the payment or recovery. In the case of the fidelity insurer, it may find that it faces a preference action to avoid a recovery long after its file is closed.

G. SOME SUGGESTIONS FOR TERMS FOR JUDGMENT ORDERS AND SETTLEMENTS

A fidelity insurer that settles with the fidelity bond principal may want to be mindful of some of the procedural and substantive pitfalls of a later bankruptcy event. A judgment lien that remains unrecorded or that is later recorded within the 90-day preference period can be avoided as a preference.

It is not unusual for a fidelity insurer to enter into a settlement agreement or consent judgment that involves the payment of money in installments with a covenant not to execute upon the judgment or not to sue provided that payments are made in accordance with agreed-upon terms. If possible, it is best to take an actual security interest or mortgage in property to secure such consensual arrangements. Although the lien or mortgage may be subject to avoidance if the fidelity bond principal is placed into bankruptcy, voluntarily or involuntarily, within ninety days of the recording of the mortgage or perfection of the lien, the 90-day period may pass and the fidelity insurer's secured interest might then be safe from avoidance.

The fidelity insurer should also make sure that any consensual payment terms reflect in the agreement or order the nature of the underlying debt with an acknowledgment by the fidelity bond principal that the debt arises out the specific fraudulent and dishonest acts the principal committed. Such an admission can be used later in an adversary action to determine whether the debt is nondischargeable.

IV. The Bankruptcy Abuse Prevention Act

The 2005 changes to the Bankruptcy Code directly impact many of the issues that fidelity insurers confront in bankruptcy proceedings. A discussion of substantive bankruptcy issues affecting fidelity insurers will be addressed as part of the discussion of these changes. The changes wrought by the new Act are comprehensive and sweeping. This discussion will only address those changes that appear to significantly impact issues confronted by fidelity insurers in the bankruptcy. Some of the provisions became effective immediately and others will go into effect on October 17, 2005, six months after the Act was signed by President Bush. It is expected that there will be a flood of filings in anticipation of the restrictions of the new Act. Those seeking a discharge under Chapter 7, who may not qualify under the “means” test for that relief under the Act will file before the effective date.⁸¹ Prospective Chapter 13 debtors seeking the entitlement to the discharge allowed under that chapter will likely file before the effective date of all of the provisions of the Act.⁸² Finally, corporate debtors, such as the remaining nondebtor airlines, may seek relief before the effective date of the restrictions that might limit their ability to establish key employee retention plans or limit the time frames within which they must file and confirm a plan of reorganization.⁸³

A. DEBTOR’S RIGHT TO A DISCHARGE

The Bankruptcy Abuse Prevention Act eliminates the so called “super discharge” available under Chapter 13.⁸⁴ Under the existing Chapter 13 scheme only debts for restitution in criminal cases, fines,

⁸¹ 11 U.S.C. § 707(b)(1) (effective Oct. 17, 2005).

⁸² 11 U.S.C. § 1328(h) (effective Apr. 20, 2005; all other amended portions effective Oct. 17, 2005).

⁸³ 11 U.S.C. § 503(c)(1) (effective Oct. 17, 2005) (limits the debtors’ ability to retain officers and directors for the purpose of retaining them during the bankruptcy); 11 U.S.C. § 1121(2) (effective Oct. 17, 2005) (limits extensions of time for filing a plan).

⁸⁴ Compare 11 U.S.C. § 523 with 11 U.S.C. § 1328. See also *In re Keach*, 225 B.R. 264 (Bankr. D.R.I. 1998) (“[T]he so-called ‘super discharge’ in Chapter 13 wipes out debts that would not have been dischargeable under Chapter 7.”).

support and alimony, educational loans guaranteed by the government and for death and personal injury caused by an individual operating an automobile while intoxicated are not subject to discharge.⁸⁵ Claims for fraud and breach of fiduciary duty were dischargeable upon the completion of the payments in a Chapter 13 plan. The claim of a fidelity insurer against a dishonest employee causing a loss under a policy, therefore, could be satisfied and discharged through a three-year payout under a Chapter 13 plan, even if the debt to the fidelity insurer was found to be nondischargeable in a prior Chapter 7 proceeding. The scope of the discharge allowed in a Chapter 13 and the ability of debtors to file consecutive bankruptcy proceedings gave rise to a strategy known as the “Chapter 20,” in which the debtor obtains a discharge of all of the dischargeable debts in a Chapter 7 proceeding, and obtains a discharge of the Chapter 7 nondischargeable debts in a subsequently filed Chapter 13 proceeding. Debtors also adopt this strategy to help cure mortgage arrearages. After October 17, 2005, a debtor will no longer be able to obtain a discharge of debts arising out of fraud by a fiduciary, embezzlement and larceny, or out of other acts, including obtaining credit with false financial statements.⁸⁶ The Bankruptcy Abuse Prevention Act eliminates this rare abuse that was more commonly encountered by creditors like fidelity insurers.

B. LIMITS ON SERIAL OR SUBSEQUENT FILINGS

The changes limit the ability of debtors to file subsequent bankruptcy cases. An individual discharged in a Chapter 7 proceeding must now wait 8 years instead of 6 years before he or she can qualify as a debtor in a subsequent Chapter 7 proceeding.⁸⁷ A debtor cannot receive a discharge in a Chapter 13 proceeding if he or she received a discharge under Chapters 7, 11 or 12 during the four-year period prior to the order of relief in the Chapter 13 case. This effectively eliminates the Chapter 20 strategy. A debtor cannot receive a discharge in a Chapter

⁸⁵ 11 U.S.C. § 1328(a) (2005).

⁸⁶ 11 U.S.C. § 523(a)(2), (a)(4) (effective Oct. 17, 2005).

⁸⁷ 11 U.S.C. § 727(a)(8) (2005) (effective Oct. 17, 2005).

13 case if he or she received a discharge in a prior Chapter 13 within two years of the subsequently filed case.⁸⁸

The Bankruptcy Abuse Prevention Act also limits the protection of the automatic stay where a single debtor has filed cases serially after the dismissal of a prior case.⁸⁹ If a debtor files a Chapter 7, 11 or 13 case within 1 year of the dismissal of a prior case, the automatic stay will be lifted thirty days after the filing of the subsequent case, unless a party in interest demonstrates that the subsequent filing is in good faith, in which case the court may order an extension of the automatic stay.⁹⁰ If two or more Chapter 7, 11 and 13 cases have been pending for the same debtor within one year of filing yet a third case, the automatic stay does not go into effect when the case is filed.⁹¹ Within thirty days after the filing of such a third case, the court may order the stay in effect with respect to all creditors, subject to some limitations, upon a showing that the filing is on good faith with respect to the creditors subject to the stay.⁹²

C. LIMITS ON WHO MAY OBTAIN A CHAPTER 7 DISCHARGE

The Bankruptcy Abuse Prevention Act limits access of individuals to Chapter 7 by creating a means test. If an individual does not meet the means test to qualify for Chapter 7 relief, the case can be dismissed, or, with the consent of the debtor, converted to a Chapter 11 or 13.⁹³ If the debtor does not meet the means test to qualify for a Chapter 7 proceeding, the Chapter 7 proceeding is presumed to be an abusive case filing.⁹⁴ The traditional grounds for finding an abuse in filing a case, such as, bad faith, can still apply in a Chapter 7 case for a debtor who otherwise qualifies under the means test.⁹⁵

⁸⁸ 11 U.S.C. § 1328(f) (effective Oct. 17, 2005).

⁸⁹ 11 U.S.C. § 362(c)(3) (effective Oct. 17, 2005).

⁹⁰ 11 U.S.C. § 362(c)(3)(B) (2005).

⁹¹ 11 U.S.C. § 362(c)(4)(A) (effective Oct. 17, 2005).

⁹² 11 U.S.C. § 362(c)(4)(B) (effective Oct. 17, 2005).

⁹³ 11 U.S.C. § 707(b) (effective Oct. 17, 2005).

⁹⁴ 11 U.S.C. § 707(b)(2) (effective Oct. 17, 2005).

⁹⁵ 11 U.S.C. § 707(b)(2) (effective Oct. 17, 2005).

To determine whether an individual qualifies for a Chapter 7 proceeding, one must first determine if the debtor's monthly income exceeds the state median income for the state in which the debtor resides. If a debtor is in the bottom 50% of his or her state's monthly median income, then there can be no finding of abuse based on the means test.⁹⁶

If the debtor has a monthly income that is in the upper 50% of the residents of his or her state, the debtor must then meet the requirements of the means test. The means test is an excess income test based on a fairly complicated formula for living expenses, transportation, rent, and adopting IRS standards for some of the values.⁹⁷ After reducing the debtor's income by the specified allowable deductions, the court will presume that abuse exists in seeking relief under Chapter 7 if the debtor's current monthly income reduced by the allowable expenses and multiplied by sixty is not less than the lesser of 25% of the debtor's nonpriority unsecured claims, or \$6,000, whichever is greater, or, \$10,000.⁹⁸ A debtor who fails to meet the means test is subject to dismissal by motion of the U.S. Trustee, the bankruptcy court or any party in interest.⁹⁹ In cases where the debtor's median income is less than the state median, or the debtor's excess income is less than the threshold amounts in the means test, only the U. S. Trustee and the bankruptcy court have standing to seek dismissal of the bankruptcy case.¹⁰⁰

This change will limit access to Chapter 11 relief, especially for individuals in the upper-middle income and high income brackets. It may increase the number of Chapter 11 and Chapter 13 filings.

D. CHANGES TO CHAPTER 11 AND CHAPTER 13

A debtor who does not meet the means test and faces dismissal of his or her case may choose to convert the case to a proceeding under

⁹⁶ 11 U.S.C. § 707(b)(7) (effective Oct. 17, 2005).

⁹⁷ 11 U.S.C. § 707(b)(2) (effective Oct. 17, 2005).

⁹⁸ 11 U.S.C. § 707(b)(2)(A) (effective Oct. 17, 2005).

⁹⁹ 11 U.S.C. § 707(b)(1) (effective Oct. 17, 2005).

¹⁰⁰ 11 U.S.C. § 707(b)(1) (effective Oct. 17, 2005).

Chapter 11 or Chapter 13. In order to qualify for a plan under Chapter 13, the debtor's debts cannot exceed the thresholds prescribed in that chapter.¹⁰¹ There are changes to the treatment of debtors in these chapters that might influence whether they elect to convert or go along with the dismissal of the case.

If a debtor's income exceeds the means test, The Bankruptcy Abuse Prevention Act requires that the Chapter 13 plan must be for a period of 5 years, instead of 3 years, unless the plan provides that all unsecured claims are paid in full over a shorter time period.¹⁰² Chapter 13 will now be a less attractive debt adjustment strategy for an individual with income over the limits prescribed in the means test. The other alternative for an individual with income greater than the limits of the means test is Chapter 11, which under The Bankruptcy Abuse Prevention Act now requires the individual debtor to include within the property of the estate post-petition income earned after the filing of the petition until the effective date of a plan.¹⁰³ This provision will increase the property of the estate for the creditors and thwart the ability of high wage earners to shield their income from their creditors.

E. TREATMENT OF THE HOMESTEAD EXEMPTION AND OTHER EXEMPT PROPERTY

The Bankruptcy Abuse Prevention Act prescribes limits on the applicable homestead exemptions that apply in bankruptcy cases. The homestead exemption provisions became effective immediately. Although Congress can prescribe what exemptions will apply in a bankruptcy case to entitle an individual to the privilege of a discharge under the Bankruptcy Code, it cannot legislate for the states what property is exempt under state law. A debtor faced with unfavorable treatment of property exemptions under the Code may simply elect to forgo bankruptcy and shield his or her assets behind the exemptions afforded under state law. The decision facing future debtors may be whether to seek the protection of federal law by filing a bankruptcy

¹⁰¹ 11 U.S.C. § 109(e) (effective Oct. 17, 2005).

¹⁰² 11 U.S.C. § 1322(d)(2) (effective Oct. 17, 2005).

¹⁰³ 11 U.S.C. § 1123(a)(8) (effective Oct. 17, 2005).

proceeding or to avoid bankruptcy in favor of the protection of state law exemptions.

Before the enactment of The Bankruptcy Abuse Prevention Act, the Code provided debtors the election to choose the federal exemptions or the state exemptions unless the debtor's state opted out of the federal exemption scheme.¹⁰⁴ A large majority of states opted out of the federal exemptions.¹⁰⁵

The new exemptions for personal property become effective in October while the homestead exemptions became effective upon enactment of The Bankruptcy Abuse Prevention Act. The purpose of this change is to prevent debtors from forum shopping by choosing to reside in states that have unlimited or very high homestead exemptions. How this will prevent judgment debtors from forgoing bankruptcy relief and seeking the protection of the laws of those states with favorable and generous exemptions remains to be seen.¹⁰⁶

¹⁰⁴ 11 U.S.C. § 522(b)(1) (2005).

¹⁰⁵ Illinois opted out of the federal exemptions. 735 ILL. COMP. STAT. 5/12-1006(a)(i) (2005). More than 30 states have opted out of the federal exemptions under the prior Bankruptcy Code scheme. See Honorable Margaret Dee McGarity, *The Basics: Debtor's Duties, Exemptions, Discharge and Dischargeability*, 796 PLI/Comm 181, 188 (Nov.-Dec. 1999).

¹⁰⁶ A decision from the United States Bankruptcy Court for the District of Arizona has already ruled that the homestead exemption provisions in The Bankruptcy Abuse Prevention Act apply only to cases where a debtor can elect either state or federal homestead exemptions. *In re McNabb*, 326 B.R. 785 (Bankr. D. Ariz. 2005). The court held that the homestead exemption provisions do not apply in the more than thirty states that opted out of the federal exemptions. Moreover, of the states that did not opt out of the federal exemptions, and in which a debtor can elect either the federal or state exemptions, only two, Texas and Minnesota, have more generous homestead exemptions than the federal exemptions as amended by The Bankruptcy Abuse Prevention Act. The decision recognized that Congress probably did not intend that such a sweeping change in the homestead exemption would affect debtors in Texas and Minnesota only, but noted that the literal language of the statute applied the homestead exemption cap only where the debtor had an election of which exemption shall apply. This case is a portent of the litigation that is likely to follow this legislation and perhaps reflects the

Under the new provisions, to qualify for a particular state's homestead exemption, the debtor must have been domiciled in the state 730 days immediately prior to the filing of the case.¹⁰⁷ If the debtor has not been domiciled in one state for a full 730 days, then the domicile for the homestead exemption will be the state in which the debtor's domicile was located for 180 days immediately prior to the 180-day period or for a longer portion of such 180-day period than in any other place.¹⁰⁸ Any addition to the value of the homestead made during the period of ten years prior to the filing of the petition from nonexempt funds, and made with an intent to hinder, delay or defraud creditors is not protected by the state homestead exemption.¹⁰⁹ Moreover, any value added to a homestead within 1215 days of the date of the filing of the petition is not protected by the state homestead exemption, except to the extent that it consists of an interest transferred from a debtor's previous principal residence acquired prior to the beginning of such 1225-day period into the debtor's current residence in the same state.

A debtor may not exempt in a bankruptcy proceeding more than \$125,000 of the value of a homestead acquired within 1215 days of the date of filing for relief, except if the homestead is a family farm or the rollover of the value into another homestead acquired within the same state.¹¹⁰ The \$125,000 homestead exemption cap also applies if the debtor, within the five years preceding the filing of the petition, has been convicted of a felony which under the circumstances demonstrates the bankruptcy case to be an abuse or if the debtor owes a debt arising out of various securities statutes or from criminal, intentional or reckless misconduct that causes serious personal injury or death to another.¹¹¹

hostility that some of the bankruptcy courts may have in enforcing The Bankruptcy Abuse Prevention Act against debtors.

¹⁰⁷ 11 U.S.C. § 522(b)(3)(A) (effective Apr. 20, 2005).

¹⁰⁸ 11 U.S.C. § 522(b)(3)(A) (effective Apr. 20, 2005).

¹⁰⁹ 11 U.S.C. § 522(o) (effective Apr. 20, 2005).

¹¹⁰ 11 U.S.C. § 522(p)(1) (effective Apr. 20, 2005).

¹¹¹ 11 U.S.C. § 522(q)(1) (effective Apr. 20, 2005).

The new provisions include IRA accounts within the exemptions. The individual exemption for retirement accounts is now capped at \$1 million.¹¹²

F. DISCLOSURE OF FINANCIAL INFORMATION

The Bankruptcy Abuse Prevention Act amends section 521 of the Code to require additional disclosures of financial information by debtors. Within forty-five days after the filing of the petition, the debtor must file a list of all creditors, schedules of assets and liabilities, schedules of current income and expenses, a statement of the debtor's financial affairs, copies of all paystubs received sixty days before the filing date, an itemized statement of monthly income, a statement disclosing the reasonably anticipate increases in income or expenses over the twelve month period following the date of filing.¹¹³ The debtor must also certify that he or she obtained the requisite credit counseling before filing the petition.¹¹⁴ The failure of the debtor to provide this information within forty-five days, or within an additional forty-five days if extensions are allowed by the court, will result in the automatic dismissal of the case.¹¹⁵

The new provisions also require the debtor to file with the bankruptcy court income tax returns for the three years preceding the petition. The debtor is required seven days prior to the first meeting of creditors to provide to the trustee and any creditor requesting a copy, a copy of the tax return filed before the filing of the petition. Unless the debtor can demonstrate circumstances beyond his or her control, the court must dismiss the case for the failure to provide this information.

G. OTHER PROVISIONS AND SOME OBSERVATIONS

There are a myriad of other provisions in The Bankruptcy Abuse Prevention Act. The foregoing are some of the key provisions that will have an impact on the fidelity insurer. The new provisions require pre-

¹¹² 11 U.S.C. § 522(n) (effective Apr. 20, 2005).

¹¹³ 11 U.S.C. § 521(a)(6) (effective Apr. 20, 2005).

¹¹⁴ 11 U.S.C. § 521(b)(2) (effective Oct. 17, 2005).

¹¹⁵ 11 U.S.C. § 521(a)(6)(B) (effective Oct. 17, 2005).

and post-petition credit counseling, limit the ability of Chapter 11 debtors to extend the exclusive period for filing a plan, and expand the duties of debtors and debtors counsel.¹¹⁶ These other provisions do not specifically deal with issues that directly affect fidelity insurers. Looking at the scope of the provisions and the administrative task in front of the courts and practitioners, one can expect a very expensive, arduous and uncertain transition in adapting these new provisions into practice.

V. A Survey Of Some Bankruptcy Cases

Most of the discussion to this point has focused more on the fidelity insurer's salvage through the bankruptcy process. A fidelity insurer will also find itself in the bankruptcy courts defending actions brought by debtors or trustees seeking recovery for losses claimed under the policy. The reported decisions relating to fidelity insurers are infrequent. A review of several decisions may assist in understanding what issues often arise and how those issues are treated by the bankruptcy courts. Because bankruptcy cases involve trustees who take control of debtor companies, where the trustees seek recovery from fidelity insurers issues involving the discovery of losses and the nature and role of prior employees, directors or shareholders who may have contributed to or cause the loss tend to arise.

A. A FIDELITY INSURER CAN CLAIM SETOFF TO REDUCE OR ELIMINATE A CLAIM

An Ohio bankruptcy court granted summary judgment in favor of a fidelity insurer finding that the insurer was entitled to set off the obligation it owed the debtor for the fidelity claim against the amount it paid for losses on a bond securing the debtor's self insured worker's compensation obligations to the state of Florida and other bonds.¹¹⁷ In the *Roberds* bankruptcy case American Motorists Insurance Company paid over \$1 million in claims on various bonds after the company filed for bankruptcy relief. The debtor later filed an adversary complaint seeking between \$600,000 and \$700,000 in compensatory losses it

¹¹⁶ 11 U.S.C. § 106(a) (effective Oct. 17, 2005).

¹¹⁷ *In re Roberds*, 285 B.R. 651 (Bankr. S.D. Ohio 2002).

claimed were recoverable under a fidelity policy issued by American Motorists. In the adversary proceeding, American Motorists affirmatively asserted that assuming Roberds' fidelity claim was valid, it would be entitled to set off the amount due Roberds for the fidelity loss to reimburse or indemnify American Motorists for other losses on Roberds' bonds. The bankruptcy court held that section 553 of the Code preserves the right to setoff and that the evidence established that American Motorists would certainly be entitled to a setoff equal to the value of the claim asserted in the adversary action.

A lesson from this case, especially where an insurer may make other contracts with the debtor company, is the insurer should be aware of setoff and recoupment rights. The unpaid pre-petition premium should reduce the claims arising out of pre-petition events. The debtor may owe the company on other obligations giving rise to the right of setoff. Procedurally, the automatic stay should be lifted to exercise setoff as that is explicitly required under the terms of section 362 of the Code.¹¹⁸

B. LIQUIDATION ACTION UNDER SIPA SUBJECT TO THE BANKRUPTCY CODE

Securities Investor Protection Act ("SIPA") liquidation proceedings are conducted in accordance with certain provisions of the Bankruptcy Code.¹¹⁹ In *In re Government Securities Corporation*, a fidelity insurer defending an adversary action brought by the liquidator argued that coverage terminated under the provision of the policy that purported to terminate liability under the policy upon takeover by a receiver or liquidator.¹²⁰ The Eleventh Circuit held that the anti-termination provisions of the Bankruptcy Code applied in a SIPA liquidation and that the policy could not automatically terminate.¹²¹

¹¹⁸ 11 U.S.C. § 362(a)(7) (2005).

¹¹⁹ Securities Investor Protection Act of 1970 §§ 5(d), 8(c), 9(b)(2), *as amended*, 15 U.S.C.A. §§ 78eee(d), 78fff-2(c), 78fff-3(b)(2); 18 U.S.C.A. § 1964(c).

¹²⁰ *In re Government Securities Corp.*, 972 F. 2d 328 (11th Cir. 1992).

¹²¹ 11 U.S.C. § 541(c)(1)(B) (2005).

C. SEVERAL ADVERSARY ACTIONS RELATING TO FIDELITY POLICIES

A trustee argued an interesting twist to the adverse domination doctrine by asserting that the misrepresentations of a corporation's former president made on an application for employee dishonesty insurance could not be imputed to the insured/debtor, and so the policy should not be voided because of these misrepresentations.¹²² Adverse domination is a doctrine often asserted by trustees and other estate representatives in arguing that knowledge of prior dishonesty by prior employees should not be imputed to the insured. The doctrine is generally asserted to argue suit limitations should be tolled.¹²³ In *In Re Payroll Express*, the court rightly noted that the law of restitution should not permit a party to disclaim an agent's fraud and retain the benefit obtained by fraud in granting summary judgment for the insurer.

In *In re Prime Commercial Corporation*, the bankruptcy court granted summary judgment for the fidelity insurer, holding that the chief executive officer who caused the loss did not fall within the policy's definition of employee.¹²⁴ The opinion in that case perhaps summarizes the typical argument of a bankruptcy trustee and the response of the fidelity insurer in the following paragraph:

The Trustee's argument that the court should be concerned with a policy to protect the rights of creditors misses the point that it is a contract that we are interpreting. Cases involving fidelity policies are not about balancing the rights of creditors with the interest of the insurer to not pay a thief. They are about

¹²² *In re Payroll Express Corp.*, 186 F.3d 196 (2d Cir. 1999).

¹²³ See *Shields v. Nat'l Union Fire Ins. Co.*, 153 B.R. 677 (E.D. Pa. 1993); *Resolution Trust Corp. v. Gardner*, 798 F. Supp. 790 (D.D.C. 1992). In a case decided by the United States District Court for the Western District of Missouri, the court rejected a trustee's argument that the suspicions of the insured's employees constituted discovery of a loss by the insured within the discovery period of the bond and granted summary judgment in favor of the insurer. *In re Midwestern Companies, Inc.*, No. 87-0658-CV-W-6, 1991 WL 338323 (W.D. Mo. Apr. 3, 1991).

¹²⁴ 187 B.R. 785 (Bankr. N.D. Ga. 1995).

interpretations of contracts of insurance. The contractual obligation of the Underwriters was to insure only those regular, paid employees of the company in the normal course of business over whom Prime had the “right to govern and direct in the performance of such service.” The issue is: did Prime control Wilson’s performance.¹²⁵

Unfortunately, not all bankruptcy courts can so neatly separate the policy of the Code from the terms of a policy or contract.¹²⁶

In one case from the Western District of Pennsylvania, the court noted that the certified copy of the policy provided to the trustee did not contain the suit limitations and denied summary judgment based on the failure of the trustee to timely bring suit under the terms of the policy.¹²⁷ The court also held the insurance company must show that it was prejudiced by the late notice of potential claim by the insured. Similarly, the United States Bankruptcy Court for the Southern District of New

¹²⁵ *Id.* at 798.

¹²⁶ The court in *Payroll Express* noted the difference between New Jersey and Pennsylvania law in applying the adverse domination doctrine. A review of one of the Pennsylvania cases is instructive. In *In re Lloyd’s Securities, Inc.*, 153 B.R. 677 (E.D. Pa. 1993), the district court approved the report and recommendations of the bankruptcy court and granted summary judgment in favor of the insured and held that the knowledge of the officer committing the wrong doing could not be imputed to the insured. Discovery of the wrongdoing did not occur until the insured was placed on notice of the wrongful acts by a third party. The author could not find a reported case addressing the alter ego defense in a bankruptcy adversary proceeding relating to a claim against a fidelity policy. There would seem to be a point at which adverse domination by an employee or group of employees might be so extreme that the employee or group of employees become alter egos of the corporation. In the *Drexel Burnham Lambert Group, Inc. v. Vigilant Ins. Co.* decision, a case prosecuted by a Chapter 11 debtor-in-possession in the New York Supreme Court, the court granted the fidelity insurer’s motion to dismiss because Drexel Burnham itself pled guilty to criminal misconduct for the very acts it alleged had caused the loss and benefited from the acts and transactions in question. 595 N.Y.S.2d 999 (1993).

¹²⁷ *In re Mechem Fin., Inc.*, 167 B.R. 799 (Bankr. W.D. Pa. 1994).

York denied summary judgment finding there were questions of fact surrounding the reasonableness of the delay in the trustee giving notice of loss to the insurer.¹²⁸ The leeway that the courts might give a trustee where there is a delay in giving notice is evident in the opinion:

[W]hether or not the alleged chaos leading to the debtor's bankruptcy case is a justifiable excuse for the delayed notice should not be resolved as a matter of law. Similarly, whether or not the delayed submission of a proof of claim form more than six months after the debtor's discovery of the alleged loss is excusable and whether or not the written notice dated May 11, 1989, together with enclosed supporting documentation, will satisfy the requirement for submitting proofs of claims within six months of discovered losses, are also questions of fact which may not be determined by a motion for summary judgment.¹²⁹

This very brief survey was intended to show how bankruptcy courts treat certain issues that might arise in fidelity claim litigation. The cases suggest the courts will enforce the terms of the policies but might be inclined to give trustees the benefit of the doubt when notice and suit limitation defenses are asserted by the insurer.

VI. Conclusion

The Bankruptcy Abuse Prevention Act profoundly changes key provisions of the Bankruptcy Code. For fidelity insurers, it offers some relief from the problems that they have encountered chasing parties through the bankruptcy maze. As noted at the outset, if the scope of the change effected by these new provisions is like killing a mosquito with a shotgun, the mosquito has been that singular pest plaguing creditors like fidelity insurers. Overall, the change benefits fidelity insurers.

For sure, the changes will cause some individuals to forego seeking bankruptcy relief. If the goal was to reduce the number of

¹²⁸ *In re J.T. Moran Fin. Corp.*, 147 B.R. 335 (Bankr. S.D.N.Y. 1992).

¹²⁹ *Id.* at 339.

bankruptcy cases overall, then this legislation might succeed. If the goal was to reduce the expense and uncertainty of the bankruptcy process, its success may be uncertain. Credit abusers and dishonest folks are fairly resourceful in finding ways to shirk their obligations. It is said that only honest folks pay their judgments. In the long run the effect of The Bankruptcy Abuse Prevention Act may be to cause certain individuals to forgo federal bankruptcy protection and seek protection under state law. This reform may prove costlier for the creditors who sought these changes to eliminate the abuse in the bankruptcy process.