Bankruptcy and Insurance

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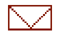
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Klaus, Kathleen H., | May 26, 2008

Despite the worsening economy, most of you will never file for bankruptcy. Most of you however will face a client who is contemplating a bankruptcy or even files one. They may turn to you with questions about their rights and obligations under the insurance policies you have sold them. The bankruptcy process can be a snake pit for the uninitiated and many of the rules and procedures in the bankruptcy process do not seem fair or logical. Also, the law in this area is constantly changing and the rule that is followed in one case may not apply a later case. The safest answer to the question of what you should do when your bankrupt client owes premium: do nothing. There is nothing you can do as an insurance agent that will affect the rights and obligations of your clients. Those rights and obligations are defined by the bankruptcy code and the insurance contract.

General Outline of Bankruptcy Process.

To better understand why insurance agents should not put themselves in the middle of their client's bankruptcy, it is necessary to have a general understanding of some of the principal aspects of the bankruptcy process. The bankruptcy code is a federal statute that applies in all 50 states. The Founding Fathers decide when the passed the United States Constitution that federal courts and federal laws would control bankruptcy matters. Unlike laws and regulations related to insurance, then, bankruptcy laws are the same all across the country.
The current bankruptcy code allows generally for five types of bankruptcy cases, each under a different "chapter" of the code. Individuals typically file either a chapter 7 case or a chapter 13 case. A chapter 7 requires the debtor to surrender all of his assets to a trustee who sells them and distributes the proceeds to the debtor's creditors equally. The distribution is usually a small fraction of what the creditor is owed. All of the debts the debtor had at the time he filed are "discharged" meaning the debts are considered

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paid in full and the creditor cannot attempt to collect the debt again. Some debts, like child support payments, are not dischargeable under any circumstances.

A chapter 13 case requires the debtor to submit a plan that calls for him to pay his creditors a percentage of his disposable income over a set period, usually three to five years. It is easier for a chapter 13 debtor to keep some of his assets and amendments to the bankruptcy code make this the favored type of bankruptcy for debtors who are employed. After the payments under the plan are all made, the debts subject to the plan are discharged.

Businesses may file either a chapter 7 case or a chapter 11. There is no "discharge" of debts for businesses. In a chapter 7, the business-debtor surrenders its assets to a trustee and closes its doors. A chapter 11 case allows the business-debtor to reorganize its business by canceling or "rejecting" unfavorable agreements with vendors and customers, selling unprofitable parts of its business and agreeing to pay its creditors a portion of their debt over time. A business debtor in chapter 11 submits a plan of reorganization that shows the court and the creditors the changes the debtor intends to make to its business that will allow it to be profitable in the future. A chapter 11 plan typically contains a provision that bars existing creditors to attempt to collect their debts after the bankruptcy process is complete. It is the chapter 11 equivalent of a discharge that individual debtors get through a chapter 7 or a chapter 13 case.

Another important provision of the bankruptcy code that applies to all bankruptcy cases regardless of which chapter the debtor filed under is the "automatic stay." This section of the bankruptcy code prohibits any one – including insurance companies who are owed premiums -- from taking any action that impairs a debtor's property without permission from the bankruptcy court. The automatic stay takes effect as soon as a case is filed. There are severe penalties that may be lodged against creditors who know that the debtor is in bankruptcy and violate the stay by repossessing a debtor's car or taking some other action that impairs the debtor's property rights. The automatic stay is designed to ensure that all of the debtor's property is preserved for the benefit of all of his creditors and not just those who are most aggressive at collecting their debts. Because the bankruptcy code is "supreme" under the United States Constitution, a creditor's rights under state law are trumped by this section of the bankruptcy code.

The final general principle to understand when thinking about how a bankruptcy may affect your clients, is the concept of the bankruptcy estate. An estate is created in all chapters under the bankruptcy code as soon as the bankruptcy case is filed. The bankruptcy estate consists of all of the debtor's property, including insurance policies. The trustee is appointed by the bankruptcy court in chapter 7 cases to "administer" the estate, which means the trustee gathers all of the debtor's property and reviews all of the claims against the debtor, to see which ones are valid and should be paid. In a chapter 13 case, a trustee is appointed to ensure that the proposed plan is fair to creditors but he does not gather and dispose of assets like a chapter 7 trustee does. In a chapter 11, the debtor maintains control of his assets, but cannot dispose of them outside of the ordinary course of business, without court approval after notice to all of the creditors.

Thus, a client who is a debtor in bankruptcy has different rights and obligations, depending on which section of the code he files for bankruptcy under. There are heavy penalties associated with taking actions that may be contrary to the debtor's interest and a trustee may actually "own" the insurance policy you sold your client.

What May Happen to that Policy You Sold When Your Client Files for Bankruptcy.

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Once your client files for bankruptcy, the insurance policy you sold becomes property of your client's bankruptcy estate and subject to all of the bankruptcy laws and regulations. This includes the automatic stay which would prohibit anyone from interfering with a debtor's right under the insurance policy. As a general principle, a debtor has an obligation to honor his contractual obligations while in bankruptcy if he wants to continue to obtain the benefits of the contract, including an insurance policy. So, a chapter 13 debtor will usually submit a proposed plan that provides for the payment of insurance premiums. Because the premiums going forward are not "debts" that existed at the time the bankruptcy case was filed, they will not be compromised or treated through the plan and the debtor will have to pay the full amount of the premium.

If a debtor stops paying premium while a bankruptcy case is pending, the insurance carrier's right to cancel the policy depends on whether or not the insurance policy contains a provision that automatically cancels the policy upon failure to pay premium. If cancellation is automatic and requires no action by the carrier, then the policy cancels of its own accord and there is no violation of the automatic stay if the carrier considers the policy cancelled and its obligation to insure over. On the other hand, if there is no provision in the policy and the carrier must instead take some action – something as small as notifying the insured that the policy will be cancelled if premiums are not paid – then the carrier cannot cancel the policy without violating the automatic stay. It must ask the bankruptcy court for permission to cancel the policy or face sanctions for taking an unauthorized action against property of the estate.

Liability policies present a unique problem, because a third-party who is injured by someone in bankruptcy needs court permission to either file or continue a suit against the debtor. Although the insurance policy is technically property of the estate, the proceeds of a liability policy are not. In other words, the proceeds of a policy do not pass into a bankruptcy estate – they are paid directly to the injured-creditor whose claim is covered under the policy. An injured-person's attorney will typically file a motion with the bankruptcy court seeking relief from the automatic stay, in order to bring a claim against the debtor, but not the debtor's estate. This means that the lawsuit will proceed outside of the bankruptcy process because the injured-party is not seeking his share of the bankruptcy estate. After a trial or settlement, the debtor's insurance company will pay the injured party directly for any covered injuries or damage. Because the money is never paid to the debtor, it is never part of the bankruptcy estate subject to the control of the bankruptcy trustee. If there is a deductible under the liability policy, the injured-creditor is entitled to a claim in the bankruptcy for the uninsured amount. They will usually waive this claim in exchange for the right to have their claim decided outside of the bankruptcy court.

Doing Nothing is Doing the Right Thing.

By the time your client as filed for bankruptcy, there is nothing you can do to help them. The time for the sound business and risk management advice you give is over and they need the advice of an attorney who specializes in bankruptcy law.

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