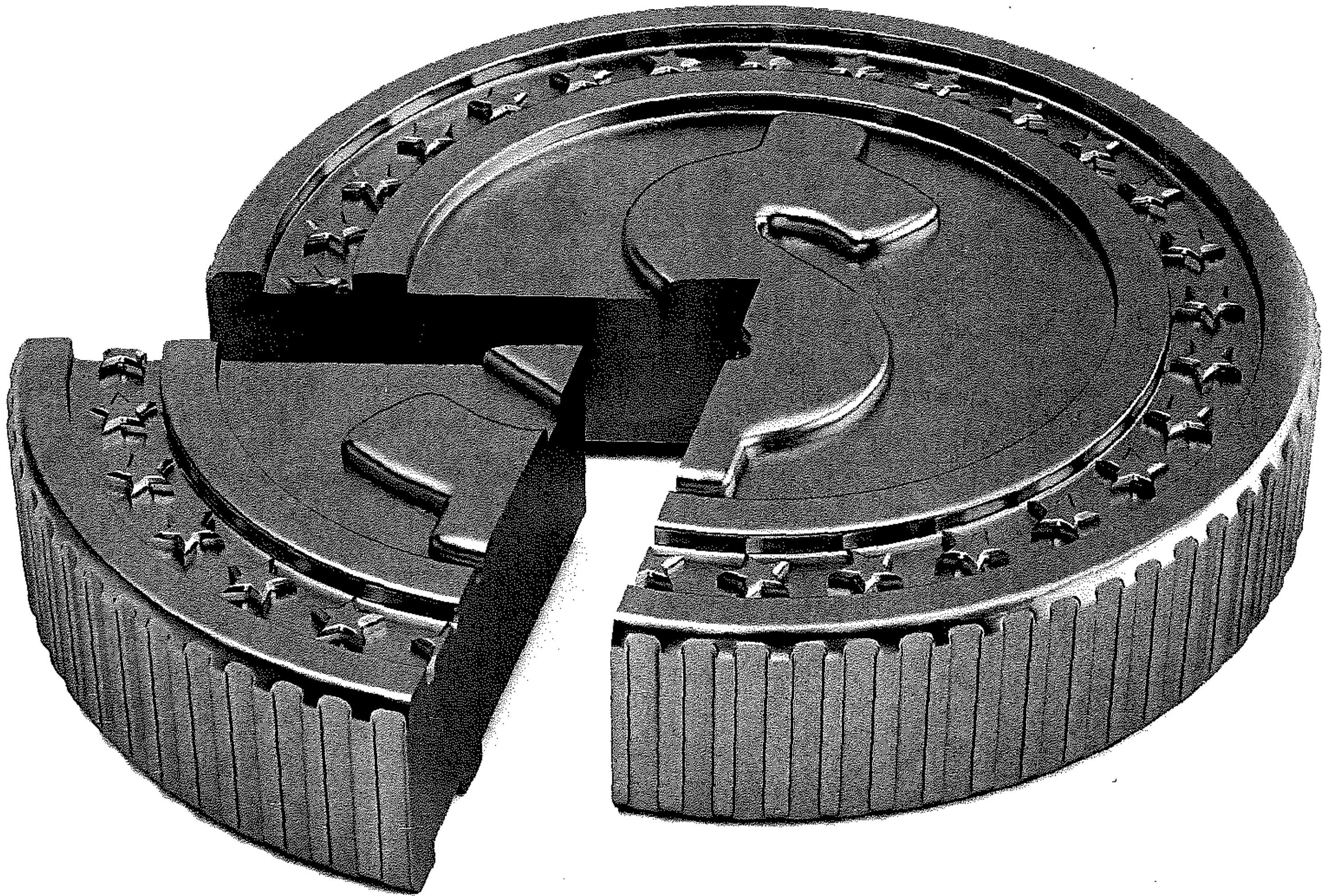

TRUSTEE ADMINISTRATION OF DEBTOR'S LIABILITY INSURANCE PROCEEDS

When Debtor's Liability Insurance Proceeds are Inadequate to Cover All Claims Potentially Falling within the Available Coverage, the Proceeds are Property of the Bankruptcy Estate but Liability Insurance Proceeds in Multiple Claimant Scenarios Should Always be Property of the Estate

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KEY POINTS

1. Debtor's liability insurance policies constitute property of the estate including proceeds but proceeds are often not administered.
2. Claims exceeding policy limits warrant bankruptcy administration of the insurance proceeds as estate property.
3. The Debtor's estate has an equitable interest in having the proceeds applied to satisfy as many creditors' claims as possible. Based upon the "secondary impact" of claims exceeding policy limits, the proceeds of a liability insurance policy are vital estate property.
4. Whether the proceeds of such policies should be administered in the estate depends upon a fact-specific determination. Where proceeds are likely to be insufficient to satisfy all covered claims, the estate's equitable interest in administering the proceeds to pay as many of the claims as possible warrant administration in the estate.
5. Creative approaches ensure that liability insurance proceeds are not only property of the estate but are administered for the benefit of the intended beneficiaries.

The issue whether proceeds of a liability policy are part of a bankruptcy estate has produced varying case law with convoluted results. Whether the proceeds of an insurance policy constitute property of a debtor's estate can have important ramifications. If policy proceeds are property of the bankruptcy estate under 11 U.S.C. § 541(a)(1), they are subject to the automatic stay, and insurers (or entities seeking payments from the policy) must seek relief from the automatic stay before making any advances or payments under the policy. Further, to the extent that policy proceeds are property of the estate, those proceeds increase the overall value of the estate for the benefit of creditors.

To resolve this issue, the court must decide whether the liability policy or its projected proceeds constitute property of the estate under Bankruptcy Code § 541(a)(1). If the court decides the proceeds of the policy are property of the estate, any act to obtain possession of those proceeds would be barred by the automatic stay. Although courts almost uniformly conclude the language of section 541(a)(1) is broad enough to cover the debtor's interest in the liability insurance policy, see, e.g., *In re Vitek, Inc.*, 51 F.3d 530, 533 (5th Cir. 1995); *MacArthur Co. v. Johns-Manville Corp.*, 837 F.2d 89, 92 (2d Cir. 1988); *Tringali v. Hathaway Machinery Co.*, 796 F.2d 553, 560–61 (1st Cir. 1986); *A.H. Robins Co., Inc. v. Piccinin*, 788 F.2d 994, 1001–02 (4th Cir. 1986); *In re Minoco Group of Cos., Ltd.*, 799 F.2d 517, 519 (9th Cir. 1986), the courts are in disagreement over whether the proceeds of a liability insurance policy are property of the estate.

Some courts have found the debtor's interest in the liability policy necessarily extends to the proceeds of the policy, and therefore conclude claimants are barred from pursuing any action to reach the insurance proceeds. *See Tringali*, 796 F.2d at 560–61 (1st Cir. 1986); *Martinez v. OGA Charters, L.L.C. (In re OGA Charters, L.L.C.)*, 901 F.3d 599 (5th Cir. 2018). Others have looked at the identity of the beneficiary or beneficiaries of the liability policy. If payments by the insurer can be made only to third parties (and not to the debtor), these courts conclude the proceeds do not constitute property of the estate and are therefore not protected by the automatic stay. See *In re Edgeworth*, 993 F.2d 51 (5th Cir. 1993) (holding the proceeds of a physician's liability policy were not part of the physician's bankruptcy estate). Such an approach may be particularly relevant for directors' and officers' liability policies. See, e.g., *In re Louisiana World Exposition, Inc.*, 832 F.2d 1391 (5th Cir. 1987).

A different approach may be necessary if the claims against the debtor exceed the expected liability insurance coverage, so failure to enjoin actions to recover under the policy would result in a race to the courthouse to seek recovery from the policy. See *Vitek*, 51 F.3d at 535. Such a race could mean unfair results between similarly situated claimants and could also prevent a bankruptcy court from marshaling the insurance proceeds, along with other assets, so as to maximize overall distributions and preserve the estate. But see *Landry v. Exxon Pipeline Co.*, 260 B.R. 769, 792–93 (Bankr. M.D. La. 2001).

The first part of this article will address current situations where courts find insurance proceeds to be property of the estate. The second section will deal with liquidating the policy in a chapter 7 case and setting up the collection mechanism.

When debtor's liability insurance proceeds are adequate to cover all claims potentially falling within the available coverage, the bankruptcy process may be unnecessary to administer the fund and relief from the stay to administer the claim/proceeds outside of bankruptcy is appropriate. On the other hand, when the proceeds are inadequate to cover all claims potentially falling

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within the available coverage or there are multiple competing interests for the proceeds, the principles of bankruptcy process dictate the proceeds are property of the bankruptcy estate for administration by the trustee. The third part of this article delves into future considerations including how to segregate the liquidation of insurance policies to be fairly distributed to intended beneficiaries while liquidating assets for the benefit of other creditors.

1. Dealing with liability insurance as property of the estate

Section 541(a) of the Bankruptcy Code broadly defines a debtor's bankruptcy estate to include "all legal or equitable interests of the debtor in property as of the commencement of the case." Pursuant to that broad definition, courts throughout the country typically have considered a debtor's insurance policies to become property of the estate upon the commencement of a bankruptcy case.[1] But even as a debtor's insurance policies themselves may be property of the estate, the proceeds of those policies may not without a close look at the facts.[2] A split of authority has developed on this issue, and the answer generally appears to depend on the type of policy and policy language at issue, though the circumstances of a case may impact the result.

Whether proceeds of an insurance policy are property of the estate is a more controversial question. In *Tringali*, the court stated "language, authority, and reason all indicate that proceeds of a liability insurance policy are 'property of the estate." *Tringali v. Hathaway Machinery Co., Inc.*, 796 F.2d 553, 560 (1st Cir. 1986) (Sec. 541(a) (1) is broad enough to cover an interest in liability insurance, namely, the debtor's right to have the insurance company pay money to satisfy one kind of debt – debts accrued through, for example, the insured's negligent behavior). Some courts have held the proceeds of specific categories of policies—such as casualty, collision, life, or fire insurance—are property of the estate, especially when the debtor is a beneficiary of the policy and when the debtor (and not a third party) is the payee. Other courts have held the debtor's right to indemnification under an insurance policy is sufficient to bring the policy's proceeds into the estate.") (citing *In re Edgeworth*, 993 F.2d 51, 56 (5th Cir.1993) (citations omitted)).

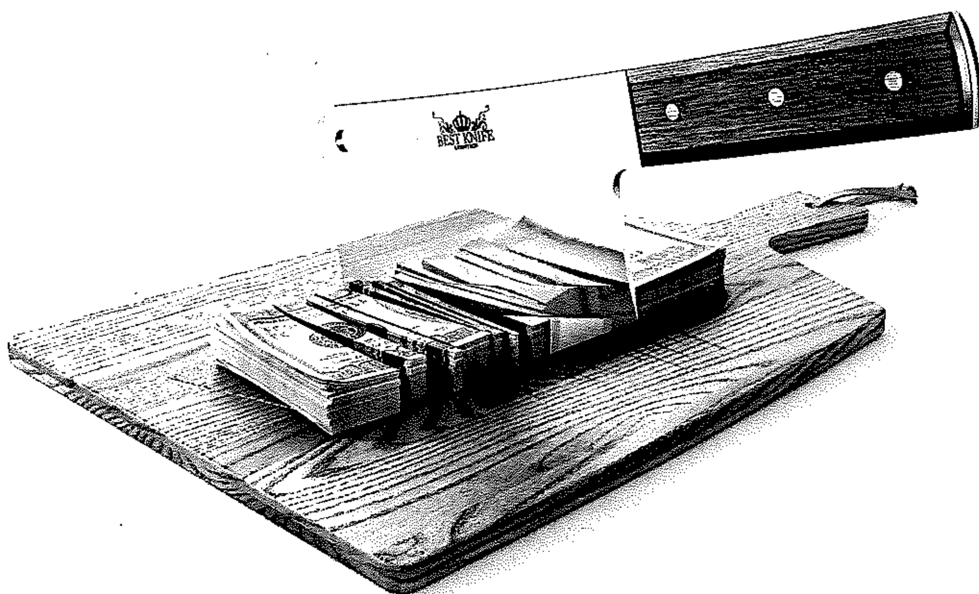
In *CyberMedica*, 280 B.R. at 13–14, the bankruptcy court analyzed an insurance policy covering the direct liability of the debtor and the liability of the debtor's directors and officers. Former directors and officers were sued and wished the insurer to bear the costs of their defense, as provided in the insurance policy. The chapter 7 trustee opposed this attempt to gain access to the policy proceeds because it had the potential to deplete funds that might otherwise be available to the estate. The court applied what it termed a "fundamental test" to determine whether the policy proceeds were property of the estate. The test was whether the bankruptcy estate is worth more with the property than without. *Id.* at 17. The court found the policy was "of benefit to the estate since the estate is worth more with it than without it because it insures the Debtor against indemnity and entity claims." *Id.* Accordingly, the court found the proceeds were estate property. *In re Focus Capital, Inc.*, 504 B.R. 296 (Bankr. N.H. 2014).

In the Fifth Circuit, the question has historically been resolved by asking who owns—or is entitled to receive—the proceeds when a claim is paid. See, e.g., *In re Louisiana World Exposition, Inc.*, 832 F.2d 1391 (5th Cir. 1987) (proceeds of policies purchased by the debtor but providing coverage for its directors and officers were not property of the estate.). Where the debtor has no right to receive and retain the proceeds of the policy, the proceeds are not property of the estate. *In re Edgeworth*, 993 F.2d 51 (5th Cir. 1991). Proceeds of first party policies and coverages are generally considered property of the estate, while proceeds of liability policies generally are not.

From a bankruptcy perspective, the purpose of asking who is entitled to retain the proceeds is to determine whether those proceeds might enhance or deplete the debtor's estate. If paying the proceeds would neither enhance nor deplete the estate—as would occur when proceeds of a liability policy are paid to a third-party claimant—the proceeds are not property of the estate under 11 U.S.C. § 541. The trustee must review not just property owned outright by the debtor (the whole bundle of sticks) but all of a debtor's rights and interests which are subject to administration. The well-known metaphor of the sticks in the bundle of property rights[3] is a helpful way to conceive of and delineate aspects of basic concepts of ownership. It articulates the specific aspects of ownership, possession or control that is at stake in any exchange or dispute. A "bundle of sticks" - in which each stick represents an individual right – is a common analogy made to explain the concept of the multiple forms of ownership of property rights. Any property owner possesses a set of "sticks" related directly to the property. For example, the named insured in an insurance policy has certain rights under the contract that include sale or assignment of the policy. Another stick, the proceeds or a beneficiary's interest, for example, may belong to someone else. Under a first-party policy, insurance proceeds are payable to the insured debtor, and so are usually considered to be property of the estate. Sometimes, however, first-party policies name a secured creditor of the debtor as a loss payee or mortgagee. In that instance, despite being payable under a first-party policy, the proceeds may not be property of the estate because they would be payable to a non-debtor third party. The phrasing of the loss payee provision – naming the secured creditor as either a sole or co-payee – is often determinative. Generally, if named as a sole loss payee, the secured creditor would take its share of the insurance proceeds up to the amount of their allowed secured claim, with any remainder going to the debtor's bankruptcy estate. However, if the secured creditor is listed as a co-payee, then the proceeds are considered property of the estate subject to the creditor's allowed secured claim. In any event, these examples illustrate that some but not all rights out of the bundle are held by the owner/insured.

Bankruptcy and insurance have been engaged in a tangled web for decades. Claimants against bankrupt insureds are often frustrated in seeking a recovery they might otherwise obtain if the insured had not gone bankrupt. The proceeds of third-party insurance policies are often not administered as property of the debtor's estate. This is because proceeds payable under third-party policies are not payable to the debtor or the trustee. In addition, the intended benefited class of an insurance policy is usually a small subset of unsecured creditors. The absolute priority rule collides with the equitable considerations underly-

ing administration of insurance proceeds. To avoid difficulties in administration, where insurance proceeds are payable to an injured claimant, the claimant often obtains relief from the stay to seek insurance proceeds outside of the bankruptcy estate.



Cases finding an insured debtor on a liability policy has an equitable interest in the proceeds have generally done so through one or more of three general theories. First, the language of a policy might provide the debtor an equitable interest if the proceeds of the policy are payable directly to the debtor. Second, a court might eschew any policy/proceeds distinction and hold the debtor has an equitable interest solely because the debtor is the named insured on the policy. Third, a court could determine the net secondary effects the payment of the insurance proceeds may have on the administration of the bankruptcy estate give the debtor an equitable interest in seeing the proceeds are paid and applied to claims against the estate.

Additionally, some courts hold the debtor does not have any interest in the liability insurance proceeds but the secondary effects those proceeds have on the estate is significant enough to warrant the imposition of an injunction under Section 105 of the Bankruptcy Code. These courts find a Section 105 injunction is appropriate to stay all litigation so company resources may be preserved and so the debtor is afforded time to devise an orderly mechanism for dealing with multiple tort claimants. *See Johns-Manville Corn v. Asbestos Litigation Grouu (In re Johns-Manville Corn.*, 40 B.R. 219,229 (S.D.N.Y.1984) (reciting resolution of insurance coverage issues in one forum would be in the best interests of all parties to the reorganization because fragmenting the relevant issues into various different forums would frustrate the prompt and effective formulation of a plan of reorganization). Courts in certain cases where liability insurance proceeds were insufficient to cover all tort claims potentially falling within the debtor's insurance coverage either have held the insurance proceeds fall within the scope of property of the estate or have enjoined litigation under 11 U.S.C. § 105 because of the "secondary effect" payment of the insurance proceeds to tort claimants will have on the remaining claims against the estate and the debtor's reorganization efforts.

Under the "secondary effect" theory, the insurance proceeds themselves are not property of the estate insofar as they are payable directly to claimants; rather, some courts have found having claims against the estate satisfied out of insurance proceeds has a "secondary effect" on the overall administration of the bankruptcy estate, since every dollar that an insurance policy pays for covered tort claims is an extra dollar for other, non-tort creditors and potentially for the debtor as well. *See A.H. Robins Co., Inc. v. Piccinin*, 788 F.2d 994, 1008 (4th Cir. 1986), *cert. denied*, 479 U.S. 876, 107 S.Ct. 251, 93 L.Ed.2d 177 (1986).

Otherwise the claimant creditors would race to the courthouse whenever a policy is too small to satisfy several potential plaintiffs. Such a race could mean unfair results as between potential plaintiffs;. It could also prevent a bankruptcy court from marshalling the insurance proceeds, and, along with other assets, arranging for their distribution so as to maximize their ability both to satisfy legitimate creditor claims and to preserve the debtor's estate. *See In re Forty-Eight Insulators, Inc.*, 54 B.R. 905, 907-08 (Bankr. N.D. Ill. 1985).

While the question of who is ultimately entitled to policy proceeds is sometimes complicated by the particular circumstances, when a policy provides both first party and third-party coverage, the answer has typically been predictable. That may no longer be the case after *Martinez v. OGA Charters, L.L.C. (In re OGA Charters, L.L.C.)*, 901 F.3d 599 (5th Cir. 2018). In the circumstances where a siege of tort claimants threatens the debtor's estate over and above the policy limits, a bankruptcy court may classify the proceeds of the debtor's liability insurance as property of the estate. Likewise, a debtor-physician's malpractice policy was property of his bankruptcy estate entitling the trustee to use his discretion to exercise debtor rights under the policy. *Olah V. Baird (In re Baird)*, 567 F.3d 1027 (10th Cir, 2009).

In *OGA Charters, L.L.C.*, a thinly-capitalized bus charter company owned an insurance policy providing $5 million in liability coverage. One of the company's two buses suffered an accident, killing nine passengers and injuring 40 others. The passengers filed claims against the bus company. Some of the passengers quickly entered into settlements with the insurance carrier, which would have exhausted the liability coverage. The victims without settlements filed an involuntary bankruptcy petition against the bus company and initiated an adversary proceeding against the insurance company, seeking to enjoin the payments to the settling passengers. The bus company's bankruptcy trustee claimed that the proceeds of the insurance policy were property of the bankruptcy estate under 11 U.S.C.A. §541(a).

The settling claimants argued that the settlements were valid under the Soriano doctrine, in which the Supreme Court of Texas held "when faced with a settlement demand arising out of multiple claims and inadequate proceeds, an insurer may enter into a reasonable settlement with one of the several claimants even though such settlement exhausts or diminishes the proceeds available to satisfy other claims." *Texas Farmers Ins. Co. v. Soriano*, 881 S.W.2d 312, 316 (1994).

The non-settling claimants argued the equitable considerations in bankruptcy should prevail, and it was unfair for many claimants to be left without a remedy. The non-settling claimants sought to have the bankruptcy court take possession of the policy proceeds, manage the numerous claims, and arrive at an equitable settlement of all claims. To do so, however, would require the bankruptcy court to find the proceeds of the liability policy were property of the bankruptcy estate.

The Fifth Circuit affirmed the Bankruptcy Court conclusion that the proceeds were property of the estate. Acknowledging some inconsistencies in the circuit's own prior decisions, the court articulated its holding:

> We now make official what our cases have long contemplated: In the "limited circumstances," as here, where a siege of tort claimants threaten the debtor's estate over and above the policy limits, we classify the proceeds as property of the estate. Here, over $400 million in related claims threaten the debtor's estate over and above the $5 million policy limit, giving rise to an equitable interest of the debtor in having the proceeds applied to satisfy as much of those claims as possible.
>
> *In re OGA Charters, L.L.C.*, 901 F.3d at 604.

Accordingly, it makes sense when the claims of multiple creditor claimants outstrip (or, perhaps, far outstrip) policy limits, and the claims that cannot be settled with the policy limits likely pushed the insured into bankruptcy – whether voluntarily or involuntarily – then a trustee ought to recognize the possibility of administering the proceeds in the bankruptcy estate.

2. Liquidating liability proceeds as property of the estate

Outside of bankruptcy, insured policyholders and insurers can enter into an agreement whereby the insurer "buys" its insurance policy back, otherwise called a "buyback agreement." These buyback agreements can operate as a type of settlement in an insurance coverage dispute. The insurer offers the insured a lump sum in exchange for an agreement to annul or cancel the insurance policy, typically after there is a loss or some other policy-triggering event. As a result of the agreement, the insured becomes self-insured. The negotiations may involve a total policy buyback whereby the contractual relationship between the insurer and its insured is completely terminated or a partial buyback limited to certain coverages, claimants or locations. Policy buyback arrangements often involve either mutual cancellation of the policy or mutual rescission. See *Texas Gas Utilities Co. v. Barrett*, 460 S.W.2d 409, 414 (Tex. 1970) ("[P]arties may rescind their contract by mutual agreement and thereby discharge themselves from their respective duties. The mutual release of the rights of the parties is regarded as a sufficient consideration for the agreement.").

The type of buyback agreement has significant ramifications for claimants. Where the policy buyout is achieved through a mutual policy cancellation, the cancellation of the policy is prospective only. This type of buyback does not extinguish liabilities that have already accrued or rights that had already vested at the time of cancellation. See, e.g., *Mann v. Charter Oak Fire Ins. Co.*, 196 F.Supp. 604 (E.D. Ark. 1961), *aff'd Charter Oak Fire Ins. Co. v. Mann*, 304 F.2d 166 (8th Cir. 1962). The cancellation will not affect an automatic retroactive extinguishment of vested rights. See, e.g., *Sid Richardson Carbon & Gasoline Co. v. Interenergy Resources, Ltd.*, 99 F.3d 746, 754 (5th Cir. 1996). However, where the policy buyback is activated through a policy rescission, the rescission will operate retroactively. See, e.g., *Douglass v. Nationwide Mut. Ins. Co.*, 913 S.W.2d 277, 279 (Ark. 1996) ("[C]ancellation is a prospective remedy and is based upon the insurer's contract rights or rights under statute, while rescission is an equitable, common law remedy which voids the contract *ab initio*.").

Many states have enacted anti-nullification statutes which operate to "freeze liability" on the part of an insurer after an injury or death occurs that triggers a claim on certain types of liability policies. These statues usually support a public policy to ensure financial responsibility in the even tof certain conduct, e.g. driving. Generally, anti-annulment statutes do not preclude an insurance company and its policyholder from agreeing to a policy annulment governing future claims. However, anti-annulment statutes will void any buyback arrangement involving third-party claims that have already occurred.

The trustee should research the involved state's law to determine whether the state has an anti-annulment statute before considering a policy buyback. Any buyback which attempts to retroactively annul the policy should be scrutinized carefully to understand whether a buyback arrangement will be legally effective.

The trustee should also review the policy to determine whether there are any additional insureds under the policy. If additional insureds are involved it is unlikely that a mutual rescission of the entire policy can take place without the consent of the unnamed additional insureds. See, e.g., *Lumbermens Mut. Cas. Co. v. Iowa Home Mut. Cas. Co.*, 405 P.2d 160 (Iowa 1965).

Buy back agreements are subject to court approval pursuant

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to Bankruptcy Rule 9019 and Bankruptcy Code. Bankruptcy Rule 9019 and the governing case law provide a settlement may be approved so long as it "falls below the lowest point in the range of reasonableness." *Myers v. Martin (In re Martin)*, 91 F.3d 389, 393 (3d Cir. 1996). Coverage litigation, which is often uncertain, complex and expensive, is particularly suitable for settlement in bankruptcy. Moreover, when insurance assets constitute a critical element of the debtor's estate, a settlement with insurers may be especially appropriate as it will permit the insured to reorganize, regain access to the credit markets, and refocus on its business operations—all of which creates value and facilitates the bankruptcy process.

A buy back settlement must also satisfy Bankruptcy Code § 363(b) (sale of estate asset) in addition to Bankruptcy Rule 9019. Bankruptcy Code § 363(b) provides, among other things, after notice and a hearing, a debtor may sell estate property out of the ordinary course of business. *See also In re Jasmine, Ltd.*, 258 B.R. 119, 123 (D.N.J. 2000) (quoting *In re Neshaminy Office Bldg. Assocs.*, 62 B.R. 798, 803 (E.D. Pa.1986)). A bankruptcy court will require a debtor demonstrate "sound business justifications" for a proposed § 363(b) transaction. *In re Lionel*, 722 F.2d 1063, 1071 (2d Cir. 1983). In general, the court will likely approve a settlement negotiated in good faith if it can be shown to be in the reasonable best interests of the debtor's estate. Bankruptcy Code § 363(f) provides a bankruptcy court may approve a sale "free and clear of any interest in such property" so long as:

(1) applicable nonbankruptcy law permits sale of such property free and clear of such interest;

(2) such entity consents;

(3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property;

(4) such interest is in a bona fide dispute; or

(5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest. 11 U.S.C. § 363(f).

Section 363(f) will be satisfied if any one of the conditions enumerated therein is met. While certain other subsections may also apply to a particular buy back settlement, § 363(f)(5) can nearly always be met, as a claimant unquestionably could be forced to accept "money satisfaction" in exchange for its interest in the debtor's insurance. Utilizing § 363(f), a buy back settlement may be structured as a sale free and clear of any liability on account of any future claims related to the policy. In other words, after the sale is consummated, future claimants against the company cannot also pursue the insurer as assignee of the policy. The policy is effectively canceled and the insurer's obligations under it are discharged.

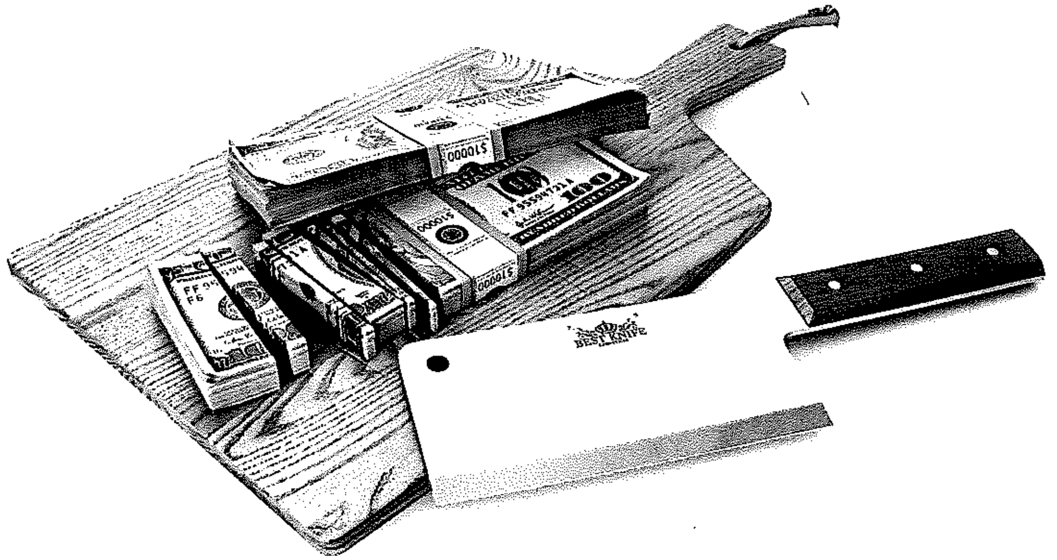
Bankruptcy Code § 363(e) further conditions a free and clear sale by requiring that each holder of an interest in the property being sold receive adequate protection. With respect to buy back agreements, claimants receive their adequate protection from (1) the settlement amount paid by the insurer, and (2) continued recourse to the debtor's profits from ongoing operations, which operations can be expected to benefit from a successful reorganization. As added protection for the settling insurer, Bankruptcy Code § 363(m) provides a properly conducted free and clear sale cannot later be disturbed as to a good faith purchaser. See 11 U.S.C. § 363(m). See also *In re Mark Bell Furniture Warehouse, Inc.*, 992 F.2d 7, 8 (1st Cir. 1993); *In re Willemain v. Kivitz*, 764 F.2d 1019, 1023 (4th Cir. 1985); *In re Vanguard Oil & Serv. Co.*, 88 B.R. 576, 580 (E.D.N.Y. 1988). As a result, barring improper collusion during settlement negotiations, 11 U.S.C. § 363(n), a court-approved buy back settlement will offer insurers protection from future actions to set aside the settlement—e.g., as a fraudulent conveyance. This § 363(m) protection is not available outside of bankruptcy

3. A proposal for the future: How to segregate the liquidation of insurance policies to be distributed fairly to the intended beneficiaries, a class of unsecured creditors, while liquidating remaining assets for the benefit of the remaining unsecured creditors.

The Bankruptcy Code provides a mechanism in a chapter 11 reorganization plan to pool liability insurance for the benefit of the third-party claimants for whom the insurance was maintained. 11 U.S.C. § 524[4] was enacted to address a specific class of creditors, distinct from general unsecured creditor pool, with recourse from liability insurance policies maintained by the debtor for recovery of damages for their proven personal or property injuries ("Third Party Claimants"). Typically, the Plan creates and funds a § 524(g) channeling trust (the "Plan Trust") out of which all present and future Third-Party Claims will be paid. The Plan Trust is typically funded by a percentage of the equity in the reorganized Debtor, as well as by insurance proceeds. All similar Third-Party Claims are placed in one Class and are resolved by the Plan Trust in the same manner, are restored to *status quo ante* and receive the same treatment as all other members of the Class. By way of example, assume debtor is a manufacturing company-which produces a food additive found to cause cancer. Debtor maintains several tranches of liability insurance to cover third party liability claims. In the chapter 11 context, in order to determine the extent of insurance coverage available for the class of tort claimants, either the debtor or insurers will seek a declaration of their rights and obligations under the insurance policies (the "Coverage Action"). In conjunction with the plan confirmation process, such debtors negotiate with their insurance carriers for a global resolution of the debtor's liability (the "Claimant Agreement"). Under the terms of the Claimant Agreement, the insurers pay into the Plan Trust, over a period of months, in full and final accord and satisfaction of all disputes between the Debtor and the insurers. The Settlement also provides insurers with a channeling injunction under 11 U.S.C. § 524(g) for third party claims that may be asserted against the insurers, and an injunction under 11 U.S.C. § 105(a) for any non-tort claims that may be asserted against the insurers.

If business debtor files a chapter 7 petition or its chapter 11 case is converted to a chapter 7 case, the chapter 7 trustee, as in any chapter 7 case, is charged with the duty to marshal and monetize assets for the benefit of the unsecured creditors. Third

party claimants, while unsecured, are a distinct class because there is an asset maintained by the debtor specifically to satisfy that class of creditors' claims – liability insurance. BUT the trustee cannot use § 524(g) and is therefore without authorization under the bankruptcy code to marshal the insurance proceeds solely for the benefit of the Third-Party Claimants. The challenge in a chapter 7 case is finding the mechanism to liquidate an estate asset for the benefit of the class of creditors for whom the asset was maintained in a manner not inconsistent with the Bankruptcy Code.



We know there are different classes of unsecured creditors in a chapter 7 proceeding. 11 U.S.C. § 507 sets forth the priorities in which trustee pays claims. § 507 classes of creditors include: domestic support obligations, administrative claims, employment related claims, and government tax claims. 11 U.S.C. § 726[5] directs the distribution of property of the chapter 7 estate in the priority order of § 507. We have also utilized 11 U.S.C. § 105 to obtain orders necessary to carry out the provisions of the Bankruptcy Code. Does §§ 507, 726 and 105 give a trustee the statutory authority to seek court approval to liquidate the liability policies for the benefit of only the third-party beneficiaries of those policies? The answer is probably no. The Bankruptcy Code also requires a distribution of the proceeds from the liquidation comply with the absolute priority rule.

In *Czyzewski v. Jevic Holding Corp.*[6], the Supreme Court held, in approving a structured dismissal, a bankruptcy court may not approve distributions to lower-priority claimants without the consent of the affected, higher-priority creditors. In a 6-2 decision, the Supreme Court emphasized the fundamental nature of the Bankruptcy Code's priority system. In 2017, the Supreme Court decided In *Jevic*, the debtor and a creditor group against the debtor under the WARN Act (a federal labor law) reached a settlement of their claims. The proposed settlement would have made payments to certain unsecured creditors, but none to the truck drivers with a higher priority than some of the unsecured claims. The lower courts approved the structured dismissal, but the Supreme Court reversed. The Supreme Court held bankruptcy courts may not approve structured dismissals that provide for distributions which violate the Code's priority rules without the consent of the affected creditors. *Jevic* makes it abundantly clear the absolute priority rule governs the distribution to all creditors whether by Chapter 7 liquidation, Chapter 11 plan confirmation, or settlement and structured dismissal. *Jervic* prohibits the chapter 7 trustee from segregating the insurance proceeds for the benefit of the claimants the policies were intended to compensate if those claimants would receive more than the same class of unsecured creditors is receiving from the liquidation of the remaining assets of the debtor.

As noted above, insurance policies are often recognized as an asset of the bankruptcy estate under 11 U.S.C. § 541. Tort Claimants who have pending claims against the debtor outside of the bankruptcy proceeding are stayed from proceeding and other claimants who have not filed a claim against the debtor are similarly stayed from commencing litigation. As a result, often claimants pursue stay relief to race to the courthouse for a judgment or settlement before the available insurance is dissipated. These stay relief applications are typically accompanied by the claimant's representation to pursue only insurance proceeds and NOT the assets of the debtor for compensation. But it is the trustee's duty to marshal the assets of the debtor and monetize those assets for the benefit of ALL unsecured creditors. Since a trustee and debtor are given the same duties under chapter 11 of the Bankruptcy Code, 11 U.S.C.A. § 1107(a[7]), it is illogical to permit a debtor in a chapter 11 to segregate an asset for a one class of unsecured creditors through the Plan Trust and § 524(g) and not permit a case chapter 7 trustee to do the same. The Small Business Reorganization Act ("SBRA" or "Sub Chapter V") of 2019[8], 11 U.S.C. §§ 1181 – 1195, enacted to streamline and make more efficient and economical a chapter 11 case, may be a new tool for a chapter 7 trustee to use.

The SBRA provides, generally, for a Sub chapter V case trustee to be appointed to mediate a consensual plan with the debtor and creditors. SBRA eliminates certain constraints imposed by a traditional chapter 11 reorganization plan such as the absolute priority rule, monthly fees paid to the Office of the United and the appointment of creditors' committees. The debtor remains in possession of its assets, unless, for cause, the debtor is dispossessed, and the appointed trustee replaces the debtor in possession of the assets and may propose a plan. SBRA does not prohibit the conversion of a chapter 7 case to one under Sub Chapter V. And, to the best of this writer's research, the Bankruptcy Code and case law does not prohibit

an insolvent non consumer bankruptcy estate from converting from a chapter 7 case to one under chapter 11.[9]

In a Sub Chapter V proceeding, the Chapter 7 trustee for the insolvent debtor's estate is better positioned to maximize the value of the assets for the benefit of the unsecured creditor constituencies (third-party claimants, general unsecured creditors) while segregating the liquidated insurance policies to be distributed through a Plan Trust for the benefit of the third party claimants. Since the absolute priority rule is inapplicable in Sub Chapter V cases, the unequal treatment of unsecured creditors is permitted. The Chapter 7 Trustee's motion to convert the insolvent chapter 7 case to one under Sub Chapter V would propose a liquidating plan with a Plan Trust to administer the third-party insurance claims, a § 524 channeling injunction to protect the insurance companies from non-third party claimants and the distribution of the fund for the other unsecured creditors derived from the liquidation of debtor's remaining assets. Under Sub Chapter V, the third party claimants would be treated fairly and equally, eliminating the risk the available insurance will be exhausted in non-bankruptcy court before the third party claim is adjudicated, the insurance companies would have a process available to avoid litigation in various non bankruptcy courts with the potential for disparate rulings and the remaining unsecured creditors would benefit from the remaining assets. A win for all parties – each class of creditors is dealt with fairly and the chapter 7 trustee performed her duties for all creditors. Until the Bankruptcy Code is amended to grant a Chapter 7 Trustee the same tools as a chapter 11 debtor to address third party claims and the liability insurance policies maintained by a debtor to pay those claims, Sub Chapter V is available.

Conclusion

When a creditor files a motion for relief from the automatic stay to seek recovery from the debtor's insurance, a trustee must carefully consider whether the relief is appropriate. When debtor's liability insurance proceeds are inadequate to cover all claims potentially falling within the available coverage or in multiple claimant scenarios, the proceeds may be property of the bankruptcy estate appropriately administered by the trustee. Without statutory guidelines, trustees may employ creative approaches to ensure that liability insurance proceeds are not only property of the estate but are administered for the benefit of the intended beneficiaries. 🏛

ENDNOTES:

[1] *See, e.g.*, *First Fidelity Bank v. McAteer*, 985 F.2d 114 (3d Cir. 1993) ; *McArthur Co. v. Johns-Manville Corp.*, 837 F.2d 89 (2d Cir.), *cert. denied*, 488 U.S. 868, 109 S. Ct. 176, 102 L. Ed.2d 145 (1988) ; *In re Louisiana World Exposition, Inc.*, 832 F.2d 1391, 1399 (5th Cir. 1987) ; *Tringali v. Hathaway Machinery Co.*, 796 F.2d 553 (1st Cir. 1986) ; *A.H. Robins Co. v. Piccinin*, 788 F.2d 994 (4th Cir. 1985), *cert. denied*, 479 U.S. 876, 107 S. Ct. 251, 93 L.Ed.2d 177 (1986) ; *In re Davis*, 730 F.2d 176 (5th Cir. 1984) ; *Wedgeworth v. Fibreboard Corp.*, 706 F.2d 541 (5th Cir. 1983).

[2] *See, e.g.*, *Landry v. Exxon Pipeline Co.*, 260 B.R. 769 (Bankr. D. La. 2001) ; *Liberty Mutual Insurance Co. v. Official Unsecured Creditors Committee of Spaulding Composites Co., (In re Spaulding Composites)*, 207 B.R. 899 (9th Cir. B.A.P. 1997) ; *In re Allied Digital Technologies Corp.*, 306 B.R. 505 (Bankr. D. Del. 2004); *Chenault v. Univ. of Ky.*, 607 B.R. 300 (E.D. Ky. 2019).

[3] *Kaiser Aetna v. United States*, 444 U.S. 164 (1979, 176) (referring to "sticks in the bundle of rights that are commonly characterized as property"); *United States v. Craft*, 535 U.S. 274 (2002, 278) ("A common idiom describes property as a 'bundle of sticks'…").

[4] 11 U.S.C. § 524 provides: (g)(1)(A) After notice and hearing, a court that enters an order confirming a plan of reorganization under chapter 11 may issue, in connection with such order, an injunction in accordance with this subsection to supplement the injunctive effect of a discharge under this section.

(B) An injunction may be issued under subparagraph (A) to enjoin entities from taking legal action for the purpose of directly or indirectly collecting, recovering, or receiving payment or recovery with respect to any claim or demand that, under a plan of reorganization, is to be paid in whole or in part by a trust described in paragraph (2)(B)(i), except such legal actions as are expressly allowed by the injunction, the confirmation order, or the plan of reorganization.

[5] 11 U.S.C. § 726 provides: (a)Except as provided in section 510 of this title, property of the estate shall be distributed—

(1) first, in payment of claims of the kind specified in, and in the order specified in, section 507 of this title, proof of which is timely filed under section 501 of this title or tardily filed on or before the earlier of—

(A) the date that is 10 days after the mailing to creditors of the summary of the trustee's final report; or

(B) the date on which the trustee commences final distribution under this section;

(2) second, in payment of any allowed unsecured claim, other than a claim of a kind specified in paragraph (1), (3), or (4) of this subsection, proof of which is—

(A) timely filed under section 501(a) of this title;

(B) timely filed under section 501(b) or 501(c) of this title; or

(C) tardily filed under section 501(a) of this title, if—

(i) the creditor that holds such claim did not have notice or actual knowledge of the case in time for timely filing of a proof of such claim under section 501(a) of this title; and

(ii) proof of such claim is filed in time to permit payment of such claim;

(3) third, in payment of any allowed unsecured claim proof of which is tardily filed under section 501(a) of this title, other than a claim of the kind specified in paragraph (2)(C) of this subsection;

(4) fourth, in payment of any allowed claim, whether secured or unsecured, for any fine, penalty, or forfeiture, or for mul-

tiple, exemplary, or punitive damages, arising before the earlier of the order for relief or the appointment of a trustee, to the extent that such fine, penalty, forfeiture, or damages are not compensation for actual pecuniary loss suffered by the holder of such claim;

(5) fifth, in payment of interest at the legal rate from the date of the filing of the petition, on any claim paid under paragraph (1), (2), (3), or (4) of this subsection; and

(6) sixth, to the debtor.

[6] 137 S.Ct. 973 (2017)

[7] 11 U.S.C.A. § 1107 provides: (a) Subject to any limitations on a trustee serving in a case under this chapter, and to such limitations or conditions as the court prescribes, a debtor in possession shall have all the rights, other than the right to compensation under section 330 of this title, and powers, and shall perform all the functions and duties, except the duties specified in sections 1106(a)(2), (3), and (4) of this title, of a trustee serving in a case under this chapter.

[8] On February 19, 2020, the Small Business Reorganization Act of 2019, enacted on August 23, 2019, became effective. The **Coronavirus Aid, Relief, and Economic Security Act or the CARES Act** S.3548 — 116th Congress (2019-2020) increased the amount of the unsecured and secured debt, excluding unliquidated, contingent and disputed debt, to $7,500,000.

[9] 11 U.S.C.A. § 706 permits a party in interest to request a case to be converted to one under another chapter of the bankruptcy code. § 706 provides: (a) The debtor may convert a case under this chapter to a case under chapter 11, 12, or 13 of this title at any time, if the case has not been converted under section 1112, 1208, or 1307 of this title. Any waiver of the right to convert a case under this subsection is unenforceable.

(b) On request of a party in interest and after notice and a hearing, the court may convert a case under this chapter to a case under chapter 11 of this title at any time.

(c) The court may not convert a case under this chapter to a case under chapter 12 or 13 of this title unless the debtor requests or consents to such conversion.

(d) Notwithstanding any other provision of this section, a case may not be converted to a case under another chapter of this title unless the debtor may be a debtor under such chapter.

See *Decker v. Office of the United States Trustee*, , 548 B.R. 813 (Bankr. D. Al 2015

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a carryback of any NOL starting after December 31, 2017, through December 31, 2020. Therefore, the NOL has to be generated in 2018, 2019, or 2020 and can be carried back up to five years, but not prior to 2015.

Start by reviewing both the individual and business bankruptcy estate tax returns filed for 2018 through 2020 for any NOLs that were generated by the estate or from an interest that the debtor had in an entity. These NOL carrybacks could potentially refund a large portion of the tax liability.

Other NOL changes under the CARES Act

Suspension of the 80 percent of taxable income limitation. This means that, if beneficial, the bankruptcy estate can deduct 100 percent of the NOL regardless of the taxable income.

Temporary Elimination of Excess Business Loss Limitations. The TCJA limited the amount of business loss that could be taken on an individual tax return to $500,000 for married filing jointly and $250,000 for single or married filing separately for 2018, 2019, and 2020 tax filing years.

Partnerships with NOLs

Revenue Procedure 2020-23 allows partnerships to file amended returns and issue amended Schedule K-1's. This allows the partners to take advantage of the revised ruling. Partnerships filing these amended returns should write "FILED PURSUANT TO REV PROC 2020-23" at the top of the amended partnership tax return.

Other issues

The pandemic has caused both the federal and state governments to execute stay at home orders, which affected the Internal Revenue Service ability to process the majority of requests. In talking with an IRS representative from the appeals division, mail has not been opened since late March when those orders were executed. The result is months of bankruptcy estate tax returns, tax payments, and power of attorney forms sitting unopened.

At the state level, some states are requesting that the prompt determinations and copies of the returns be emailed so that those state representative can review and continue processing those returns.

Power of Attorney (POA) forms continue to be problematic as the IRS fax line is still down. This makes getting tax transcripts for the bankruptcy estate extremely difficult. However, the Practitioner Priority Service (PPS) phone line is open. The PPS is staffed by IRS representatives to handle tax preparers' questions. The IRS PPS phone number is 1-866-860-4259. Your accountant who is employed by the bankruptcy estate would need to call the designated PPS line. The POA can be faxed at that point directly to the specific IRS representative. The transcripts can then be emailed using a secure portal designated to the CPA through their specific IRS e-services account. However, be prepared to be on hold for a length of time.

How can we help?

Reach out to our team at Trustee Resource Group for assistance in reviewing the CARES Act. Contact Cheryl Wesler, CPA at *Cheryl@trusteeresourcegroup.com* or visit our website at **www.trusteeresoucegroup.com.** 🏛