Knowing Your Options When A Personal Indemnitor Considers Bankruptcy Protection

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As a matter of good business practice, sureties routinely obtain indemnification agreements from individuals (and their spouses) that own, control and operate the businesses of their bonded principals or who are themselves in need of bonding. In addition, in the case of fidelity coverage, defalcations of individuals covered by financial institution bonds or commercial crime coverages resulting in payment of losses by the fidelity insurer will give rise to indemnity claims against those causing the covered loss. The resulting indemnification claims may prove worthless, when, in the case of surety indemnitors, the economic fate of the individual indemnitors is so closely tied to their business that the downfall of one is the downfall of all. And dishonest employees causing fidelity losses will rarely have sufficient assets with which to satisfy the fidelity insurer's subrogation claims.

In today's economic climate, a significant number of erstwhile high income and high net-worth personal indemnitors may soon face prolonged unemployment and a drastic change in lifestyle. Even a temporary interruption of cash flow may prove disastrous for their business, potentially resulting in personal economic ruin. For some, an extraordinary lifestyle, once marked by multiple residences, luxury automobiles, yachts, golf and social club memberships, is at risk. In turn, the surety that relied upon the once healthy net worth of an individual indemnitor faces a harsh reality: the agreed personal indemnification may be discharged or rendered worthless in a subsequent personal bankruptcy. This article will explore the alternatives available to the surety and fidelity insurer when these once high income, high net-worth individual indemnitors are forced to confront present-day economic realities, contemplate personal bankruptcy, and face a potential wholesale liquidation of personal assets.

The good news for the diligent surety and fidelity insurer is that high net worth individuals who seek to discharge indemnification obligations and otherwise avail themselves of the protections found in Chapters 7, 11 and 13 of our federal Bankruptcy Code may find that these options, by virtue of amendments to the Code, have become more limited than they once were. Each of these Code provisions now curtail the ability of high income, high net-worth individuals from gaining meaningful economic benefits as a result of seeking sanctuary in the bankruptcy court. And the obligations of defalcators will be non-dischargeable under Section 523 of the Bankruptcy Code.[1] Moreover, because there may be more viable alternatives to bankruptcy — the out-of-court, voluntary restructuring of an individual's assets and liabilities; the "short-sale" in lieu of judicial foreclosure of real property; and, in many states, an alternative to bankruptcy known as an assignment for the benefit of creditors — it behooves the surety and its indemnitors to cooperatively explore and understand all alternatives when facing a work-out of the principal's business obligations or the liquidation of an individual indemnitor's personal assets.

Chapter 7 Liquidation

In exchange for a "fresh start" — literally being able to discharge liability for almost all pre-petition, personal obligations (except for a delineated few), including indemnification under surety bonds[2] — a debtor agrees to turn over all non-exempt property to a bankruptcy trustee to convert into cash for distribution to the debtor's creditors.[3] The principal benefit of Chapter 7 is the fresh start afforded all honest debtors: wages earned and assets acquired after the bankruptcy filing date

[1] *See* 11 U.S.C. §§ 523(a)(2), (4), (6) (1978) (as amended through Dec. 1, 2010).
[2] *See id.* § 727.
[3] *See id.* §§ 521, 704, 726.

are held free and clear of all discharged, pre-bankruptcy claims.[4]

An initial barrier to a personal indemnitor seeking to discharge principally consumer debt under Chapter 7 is the individual's ability to pass the "means test," a qualifying standard recently implemented by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA") (A Chapter 7 debtor with all business debts, is eligible for Chapter 7 without limitation).[5] The first stage of the test compares the debtor's monthly income to the median income for the debtor's geographic area and household size.[6] If the debtor's monthly income falls at or below the median level, the means test is met—there is no presumption of abuse and the debtor can file for Chapter 7 bankruptcy and obtain a fresh start. If the debtor's income exceeds the geographic median, it triggers the second phase of the test: a debtor's monthly income and expenses are compared to national IRS standards to determine the debtor's disposable income (income left over after accounting for the bare necessities of life, such as the cost for shelter, food and utilities).[7] That calculation will determine if the potential debtor nonetheless qualifies for Chapter 7.

The discharge of unsecured debts, except for certain types of non-dischargeable debts that survive bankruptcy, such as, in the construction surety context, diversion of statutory and/or contractual trust funds, material misrepresentations made in procuring bonds (either orally or in written financial statements), and certain tax obligations, may be extremely beneficial for individual indemnitors, particularly if an economic downturn is short-lived and the prospects for future employment are good. Moreover, none of a debtor's income earned after the filing of a Chapter 7 bankruptcy is available to pay the claims of pre-bankruptcy creditors whose obligations are dischargeable in bankruptcy.[8] On the other hand, if a surety or fidelity insurer's debt is held to be non-dischargeable, while most if not all other debts are discharged, the surety or fidelity insurer will have the opportunity to recover from future acquired wages and/or assets without dilution by the claims of other pre-petition, discharged creditors. In the fidelity policy or fiduciary bond context, possible grounds to prevent the discharge of debts to the surety (or subrogated fidelity insurer) will occur frequently, inasmuch as such debts often arise from a crime, dishonest act, or breach of fiduciary duty by the debtor which debts are not dischargeable under Section 523 of the Bankruptcy Code.[9] Thus, it is incumbent upon the surety or fidelity insurer's claims representatives to work with bankruptcy counsel to explore all potential exceptions to a bankruptcy discharge. Doing so may substantially increase the surety or fidelity insurer's leverage in dealing with individual indemnitors and may negate the benefits *vis-à-vis* the surety or fidelity insurer of a personal bankruptcy filed by an indemnitor or dishonest employee.

Accordingly, while the initial prospect of a liquidation is bleak, the fresh start of a Chapter 7 for an individual indemnitor may inure directly to the benefit of a surety or fidelity insurer whose debt is non-dischargeable. The surety or fidelity insurer in these circumstances may have access to future wages and assets unencumbered by the bankruptcy filing.

Chapter 13 Wage Earner Plan

Chapter 13 allows individuals facing short-term financial setbacks to pay off all or some portion of their debts under a Chapter 13 repayment plan over a period of three to five years.[10] To qualify for Chapter 13, an individual must, among other requirements, have stable and regular income, which is sufficiently high so that, after payment of basic necessities, some disposable income remains with which to fund a repayment plan to unsecured creditors.[11] A successful plan avoids an adjudication as a "bankrupt," which has more favorable credit implications going forward, particularly to the extent a personal indemnitor ever seeks bonding for an affiliated principal in the future.

[4] *See id.* § 524.
[5] *See id.* § 707(b).
[6] *See* 11 U.S.C. § 707(b)(2)(A)(ii).
[7] *See id.* § 707(b)(2)(A)(ii).
[8] *See id.* § 524.
[9] *See id.* § 523(a)(2), (4), (6).
[10] *See id.* § 1322.
[11] *See* 11 U.S.C. §§ 109(e), 1325 (b).

A threshold test to determine Chapter 13 eligibility is that an individual must have no more than $1,081,400[12] in secured debt and $360,475[13] in unsecured debt.[14] Given the typical size of some bonded projects, Chapter 13 may not be available to most high net worth individuals who, after the failure of their bonded construction business, will have accumulated substantial debt, regardless of income. Moreover, those unemployed formerly high net-worth indemnitors — whose businesses have collapsed and which were the only source of income for the indemnitors — also likely will lack the "regular income" needed to fund a plan, particularly because unemployment benefits will be an insufficient source of revenue to qualify to fund a Chapter 13 Plan.

Chapter 13 offers individuals a number of advantages over Chapter 7 liquidation. Perhaps most significantly, Chapter 13 allows individuals who are behind on payments of secured debts, such as for their mortgage or car loan, an opportunity to catch up on missed payments over time, while keeping the property that secures the debt.[15] In addition, Chapter 13 allows individuals to reschedule payments for secured debts (other than for a mortgage on their primary residence) and to extend those repayments over the life of the Chapter 13 plan.[16] Congress is considering legislation to extend that kind of relief to mortgages on primary residences.[17]

A potential drawback for many personal indemnitors, who otherwise would qualify for Chapter 13, is that Chapter 13 is a viable alternative for those indemnitors who cannot qualify for a Chapter 7, <u>but</u> <u>not</u> <u>for</u> those indemnitors who are out of work or owe millions of dollars to a surety on defaulted bonded projects. Of course, an individual indemnitor's inability to file a plan to pay back debts in Chapter 13 over time often leaves the individual at the mercy of its most influential creditors, like a surety.

Chapter 11 Reorganization

A Chapter 11 filing is predominantly used by business entities, although nothing prevents an individual from using it.[18] If a high income and/or high net-worth individual fails to qualify for Chapter 7 (by virtue of the "means test") or Chapter 13 (because debt exceeds statutory limits, or he/she has no regular income to fund a plan), the individual may consider filing a personal Chapter 11. Fortunately for the surety and fidelity insurer, recent bankruptcy amendments have made it more difficult for the high net-worth indemnitor to file for Chapter 11.[19]

Before Congress enacted BAPCPA, the new bankruptcy amendments, individual Chapter 11's were relatively rare because the process was more expensive than either Chapter 7 or 13. With the BAPCPA amendments, more onerous barriers have been added. For example, under BAPCPA, property acquired by an individual debtor postpetition, including salary and other earnings, becomes property of the estate, as in Chapter 13 cases.[20] In addition, Chapter 11 now provides that an individual debtor generally does not receive a discharge upon confirmation of a repayment plan.[21] Rather, the individual receives a discharge only after completion of all payments under the plan, as occurs in Chapter 13 cases.[22] Finally, BAPCPA now imposes what amounts to a Chapter 11 "projected disposable income test" that may force the debtor to prove that the property to be distributed under the plan has a value that is not less than the projected disposable income of the debtor over a five-year period, similar to Chapter 13.[23]

An individual Chapter 11, despite the statutory obstacles and potential downside,

[12] For cases commenced before April 1, 2010, the dollar amount is $1,010,650.
[13] For cases commenced before April 1, 2010, the dollar amount is $336,900.
[14] *See* 11 U.S.C. § 109(e).
[15] *See id.* § 1306(b).
[16] *See id.* § 1322(b).
[17] Helping Families Save Their Homes Act of 2009, H.R. 1106, 111th Cong. (House Sess. 2009).

[18] *See* 11 U.S.C. § 109(d).
[19] *See, e.g.*, *id.* §§ 541(a)(7), 1129 (a)(15), 1141 (d)(5)(A).
[20] *See id.* § 541 (a)(7).
[21] *See id.* § 1141(d)(5)(A).
[22] *See id.* § 1141(d)(5)(A).
[23] *See id.* § 1129(a)(15).

nonetheless may present the only alternative for well-healed debtors to hold creditors in abeyance pending temporary economic setbacks. Accordingly, an individual indemnitor with substantial assets, separate and apart from his or her business, may at least temporarily thwart the surety's or fidelity insurer's collection efforts by filing Chapter 11. Consequently, the surety or fidelity insurer must become proactive in an individual's Chapter 11 proceeding. This means holding the individual debtor to the Code-imposed deadlines for financial disclosure; requiring court approval of almost all business decisions; actively taking depositions of the debtor and third-parties, opposing the plan process, or proposing a competing plan favorable to the surety or fidelity insurer. It is an expensive process but, when used creatively, Chapter 11 allows a great deal of court-approved discovery to locate hidden assets and an opportunity to use the bankruptcy to the surety's or fidelity insurer's advantage.

Bankruptcy Alternatives: Short Sale Foreclosure

It should be somewhat apparent to the surety or fidelity insurer, in pursuing financially precarious personal indemnitors, that bankruptcy alternatives — as a compromise to the often all-or-nothing approach of any of the three chapters of bankruptcy — may prove productive and cost efficient, especially where collateral secures a personal indemnification obligation outside of bankruptcy. With a cooperative personal indemnitor, the surety or fidelity insurer may be able to extract a far better result *vis-à-vis* other creditors outside the bankruptcy process.

For the individual indemnitor who has pledged his house as collateral and who can no longer afford to keep mortgage payments current, there are alternatives to bankruptcy and foreclosure proceedings. One option is called a "short sale." A short sale happens when a creditor or surety with a secured lien agrees to accept less than the total amount owed on a first mortgage against a home that has a market value below the amount of the secured debt, a situation commonly known as being "under water." A short sale gives the creditor a quick return on its money, an opportunity to recover more than likely could be recovered from a forced sale in bankruptcy or foreclosure, and avoids the expense and delay of either a bankruptcy or foreclosure. The potential benefit for the individual seller is to avoid the stigma, expense, and adverse credit consequences of either having to file a bankruptcy or defend a foreclosure.

There are negative consequences to a short sale. The bad news for individuals who choose short sales over Chapter 7 bankruptcy, is that the debtors could remain liable for a deficiency judgment for the difference between the loan amount and the short sale proceeds. Of course, in the surety context, the potential for the waiver of a deficiency judgment is often the "carrot" that enables the surety to obtain cooperation of the principal's owner in a default and/or takeover situation.

On the other hand, from the surety's or fidelity insurer's perspective, a short sale may be less advantageous than either a bankruptcy or a foreclosure if the property is subject to multiple liens, including second mortgages, home equity loans, and property tax arrears. The short sale cannot effectively deal with these kinds of "junior" liens and the tax arrears, which tax liens will prime even a first mortgage. Given the potential drawbacks to short sales, both from the perspective of the indemnitor and the surety or the fidelity insurer, the attorney needs to consider and understand all options before undertaking this alternative on behalf of a surety client.

The Voluntary Restructuring of Creditors' Debts

A most basic tool for a surety or fidelity insurer to consider when dealing with an insolvent or near insolvent personal indemnitor, particularly those who owe massive amounts of debt but have a limited number of creditors, is to open a dialogue with all creditors to achieve a restructuring of debts without the expense and time of a formal bankruptcy or foreclosure. This informal process — even for an individual indemnitor — is principally used by individuals with substantial assets who cannot file a bankruptcy and desperately need to renegotiate deals with creditors. Moreover, the process often can be undertaken by skilled attorneys on behalf of an individual indemnitor and the surety

or fidelity insurer, without the expense and uncertainty of a bankruptcy.

The downside is that without 100% creditor participation any one or two creditors could seek to enforce their legal rights and disrupt the voluntary workout. Similarly, the "fresh start" available in a Chapter 7 bankruptcy — whereby pre-bankruptcy, personal debts are discharged forever — is not available in a voluntary workout. That consideration, of course, is of no concern unless it prevents the indemnitor from being an effective work-out partner. In short, the voluntary restructuring of debt, at least where the creditor body is of a manageable size, is a viable alternative to bankruptcy to consider.

Assignment For the Benefit of Creditors

An assignment for the benefit of creditors ("ABC") is a state sanctioned liquidation proceeding, similar to the federal law of Chapter 7 liquidation. A little known fact, at least under New Jersey's ABC law, is that both individuals and corporate entities may file an ABC.[24] Generally, an ABC is a transfer or conveyance of all of the individual debtor's (the assignor's) assets in trust to an independent third party (the assignee), with the express authority for the assignee to liquidate the debtor's property and distribute the proceeds equitably among the debtor's creditors. In the case of a consensual workout for a failed principal and its owner/indemnitor or a defalcating debtor, the individual indemnitor/debtor (with assets to protect) is the assignor and the surety or fidelity insurer's designated counsel would be the assignee. It is a court-sanctioned proceeding, comparable to Chapter 7, but without the critical "fresh start" a bankruptcy discharge affords an individual debtor. One advantage of the ABC is the avoidance of the unpredictability and expense of having to file a Chapter 7, 11 or 13 bankruptcy. Another advantage is the ability to select the assignee to liquidate the assets, rather than having to rely upon a random appointment of a trustee in chapter 7.

The assignment for the benefit of creditors is a viable mechanism to effect a work-out where the surety/fidelity insurer and individual indemnitor/debtor are cooperating and both want to avoid the scrutiny of a bankruptcy filing. It also often is a means to allow an owner of the principal business to buy the business assets and/or sell the assets to a favorable buyer, without the auction process normally attendant to an asset sale in bankruptcy. Accordingly, there is an opportunity for a surety and its indemnitor, particularly in the construction industry, to select a replacement contractor as a potential buyer of the principal's assets in order to complete the defaulted project more economically and efficiently. This is most effective when secured lenders are on board with the transaction and most unsecured creditors are claimants under the bonds. The main downside to this kind of proceeding is that the ABC may be trumped by the filing of a bankruptcy by other creditors. Thus, like a chess game, the successful filing of an involuntary bankruptcy by other creditors subsequent to the ABC filing will transfer the venue from state court to federal bankruptcy court.

Conclusion

When a personal indemnitor contemplates a bankruptcy filing, it usually is a negative event. An educated surety or fidelity insurer, however, which understands the limitations on the availability of bankruptcy relief for certain individuals, may be able to use the individual indemnitor's bankruptcy to its advantage and, if such advantages are not reasonably available, may be able to negotiate a favorable alternative resolution outside of bankruptcy. As typically is the case, a true "workout" of a business and its owner's economic problems may yield a greater recovery than forcing a bankruptcy filing. The lesson here is that, by knowing fully all the options available, a pro-active surety or fidelity insurer can sometimes enhance its prospects for a meaningful recovery from financially distressed individual indemnitors or defalcators.

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[24] *See* N.J. STAT. ANN. § 2A:19-1 *et seq.* (West 2010).