



Legal Beat

By MICHAEL SEAN QUINN

When Agents Go Bankrupt

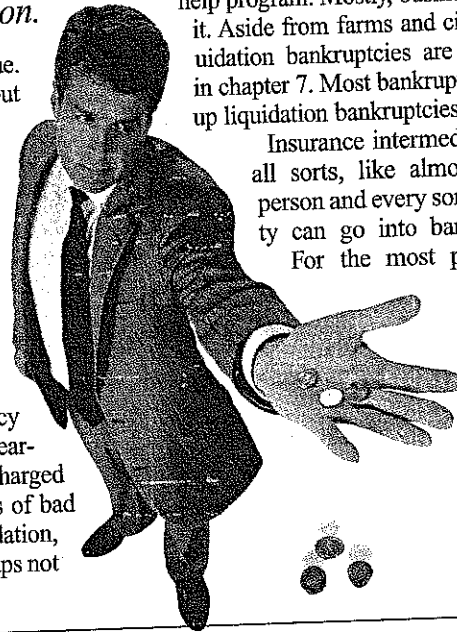
Commission structures can pose serious problems for agents going through bankruptcy. Protect yourself before you need protection.

I admit it. I have a bearish streak. When I was a boy, I firmly believed that everything always came out for the worst. After years of Pessimism-Optimism Therapy under the eminent psychologist Dr. Ferdinand Bull, I improved. (No lawyer who wishes to succeed can look out upon the world as bleakly as I did. You always settle at the wrong level. You always advise too cautiously.) Now I only believe that the best things won't last, and often things come out muddled, mixed and grayish.

One of the profound strategic thinkers of our time, Edward Luttwak, says in his book *Turbo Capitalism* that our economy is super-charged in various ways, but that it will all come to a bad end. Indeed, he thinks many people who work for a living are already being pushed into lower paying, less secure

jobs. He thinks this trend will continue.

His ideas make me worry about independent businessmen and what will happen to them next year or the year after. I am especially worried about smaller insurance agencies. For over a century, small business has been the backbone of independent Americana. Small businesses are like a hundred thousand points of light. If Luttwak is right, however, somebody needs to begin saying something about how bankruptcy works. Lots of them are around a nearby corner. If the dot.com, turbo-charged economy sputters, there will be lots of bad news, and if it leads to more consolidation, American culture will change. Perhaps not for the better.



Bankruptcy 101

Bankruptcies are of two sorts: liquidation and rehabilitation. Rehabilitation bankruptcies are of two sorts: there is chapter 13 and chapter 11. In a chapter 13, there is one trustee for everybody in a district, and she administers the payment schedules. In a chapter 11, the bankrupt debtor is called the debtor-in-possession, and it is a kind of self-help program. Mostly, businesses use it. Aside from farms and cities, liquidation bankruptcies are handled in chapter 7. Most bankruptcies end up liquidation bankruptcies.

Insurance intermediaries of all sorts, like almost every person and every sort of entity can go into bankruptcy. For the most part they

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have the same problems pretty much everyone else in bankruptcy has, and there are few problems distinctive to the insurance marketing industry. There are two problems, however, which are (almost) unique. These are the problems of commissions and licenses.

Commissions

Insurance agents are usually paid commissions. Since insurance policies are often subject to renewal, the sale of an insurance policy often involves the sale of a right or opportunity to renew by the policyholder, and agents receive commissions when policies are renewed. These entitlements are called "renewal commissions" or "expiration commissions," "expirations," sometimes "expiry commissions," and occasionally just "expiries." (The word "expiry" refers to the termination of an insurance contract, originally a life insurance contract. Thus, "expiry commission" technically is a misnomer, but one gets the idea.)

From an economic standpoint, renewal commissions are extremely important to agents. They are like investments. They are like having subordinates work for you where you have overrides on their commissions. They are perhaps the single greatest avenue to wealth available to intermediaries specifically deriving from the insurance business.

Renewal Commissions

The single most heavily litigated issue involving the entitlement of agents to commissions concerns renewal commissions. Suppose an agent has sold a policy in Yr-1, goes bankrupt in Yr-2, and the policyholder renews for Yr-3. What rights does the agent have to the renewal commission? Normally, a debtor's post-petition earnings are not the property of the estate, and they are exempt from the claims of creditors.

Should renewal commissions to which a debtor first acquires rights after the bankruptcy has been filed be treated as post-petition earnings or as something that is the property of the estate, say, because they are like proceeds of a pre-petition investment?

The overwhelming weight of authority is that renewal commissions are the property of the estate since they were fully earned pre-petition. Some courts treat this as an all-or-nothing matter: either the debtor is entitled to the renewal commissions or he is not. Other courts treat the problem differently. In one case, if no post-petition activities are necessary for obtaining the payments at issue, then they are the property of the estate. But, observed one court,

[i]f some postpetition services are necessary, then courts must determine the extent to which the payments are attributable to the postpetition services

and the extent to which the payments are attributable to prepetition services. That portion of the payments allocable to postpetition services will not be property of the estate. That portion of the payments allocable to prepetition services or property will be property of the estate.

Obviously, the latter approach is, from a theoretical perspective, the better one, although it may be difficult in practice to come up with reasonable estimates. This point is especially true since there is almost always something left to be done on every project.

Exempt Property

In many ways, bankruptcy is very simple. It is also a great example of federalism. Thus, bankruptcy is allocated to the national government by the Constitution. From time to time, Congress passes bankruptcy laws. The one currently in existence creates an estate in bankruptcy the instant the debtor files a bankruptcy petition. Property in the estate is collected, valued and distributed to creditors in accordance with an order of priority specified in the Bankruptcy Code.

Not all of the property of a debtor becomes (or, rather, stays) property of the bankruptcy estate. Some if it is exempt. For


the most part, the federal Bankruptcy Code honors the exemptions created by state law. Hence the suggestion that the Code exemplifies federalism.

Thus, whether renewal commissions are exempt property will depend upon state law. In some states, where an insurance agent is an independent contractor, and wages are exempt, renewal commissions will not count as exempt property. On the other hand, if renewal commissions constitute a kind of earnings or are specifically exempted in a state statute, then they would be exempt from the claims of creditors, even if they were part of the bankruptcy estate. Whether commissions are—or are not—exempt property is almost always open to some controversy.

Complex Commission Structures

Agents frequently have complex commission arrangements. Sometimes, insureds pay premiums monthly, and the insurers will pay the intermediary some substantial fraction of the total commission up-front, but charge it back if the insured doesn't follow through. Often, agents have override commissions on other agents, whom they train and/or supervise.

The senior agents may have some responsibility for a default on the part of a junior agent. Thus, for example, if A recruits, trains, and/or supervises B, and B



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recruits, trains, and/or supervises C, B may take an override on C, and A may take a fraction of B's override on C. What happens if C does a bunch of bad deals and disappears? The chances are that both B and A will have to repay what they received and what C received. If there is a long enough chain and/or a large enough default, an agent near the top of the chain could get into some real financial difficulties.

In cases of this sort, the trustee is tempted, by the literal language of the Code, to treat money owed for pre-petition activities as property of the estate, not subject to set-off, and not subject to recoupment. Set-off is the non-bankruptcy commercial law doctrine according to which a person who owes another money can reduce his debt by subtracting money owed to him by his creditors. Recoupment is slightly different.

It entitles someone who owes money for any reason to keep back some of it where there is an equitable reason to withhold. Recoupment differs from set-off in crucial respect. A person is entitled to recoupment only when the mutual obligations rise from the same transaction. Of course, lawyers can quibble and bicker over what constitutes the "same" transaction for a good long time.

Often, the position of the trustee is aided by individual clauses in the agency commission agreements. Generally speaking, the courts have been unsympathetic to the

claims of the trustees and favorably disposed to the claims of the insurers. Their fundamental reason is that the agents have not really had claims to commissions in the hands of the insurer until various conditions were met.

One court held that the [commission] contracts require the satisfaction of the [Agent] debtor's [daisy-chain] roll up liabil-

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to renewal commissions.*

ity as a condition precedent to the payment of commissions. With the roll-up liability unsatisfied, the debtor had no entitlement to the commissions. Consequently, the commissions withheld by the company defendant companies to satisfy this liability were not property of the debtor. Because they were not property of the debtor as of the

commencement of the case, they are not property of the bankruptcy estate.

Sometimes, an agency's right to renewal commissions hinges on state law. Some states provide that if an intermediary is terminated at-will, then he is entitled to renewal commissions, but if he is terminated for refusing to turn over funds, then he forfeits his right to renewal commissions. The use of the common law remedy of recoupment also turns closely on state law, as does the law governing set-off.

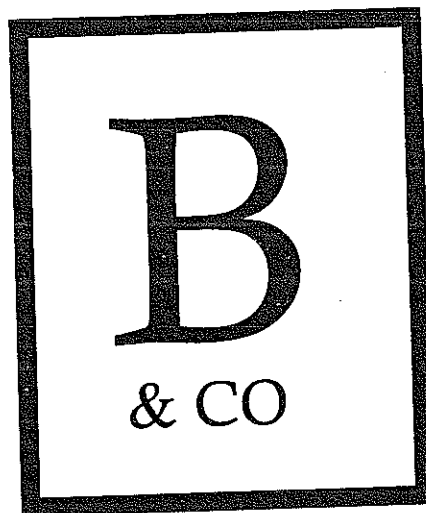
Liens Upon Commissions

At least under some circumstances, assignments of commissions can constitute liens valid in bankruptcy. In one case, an agent got himself into some sort of financial trouble and executed an "Irrevocable Collateral Assignment of Insurance Commissions." The party to whom this was assigned filed a public document creating a lien and sent notices of the assignment to insurance companies which owed the agent-assignor money. The agent went bust. He attempted to set aside the assignment and utilize the commissions to fund a rehabilitation plan. The trustee, however, moved to abandon any right to those commissions because of the assignment.

The agent resisted. The court held that the assignment of commissions was not an assignment of wages. There is an important

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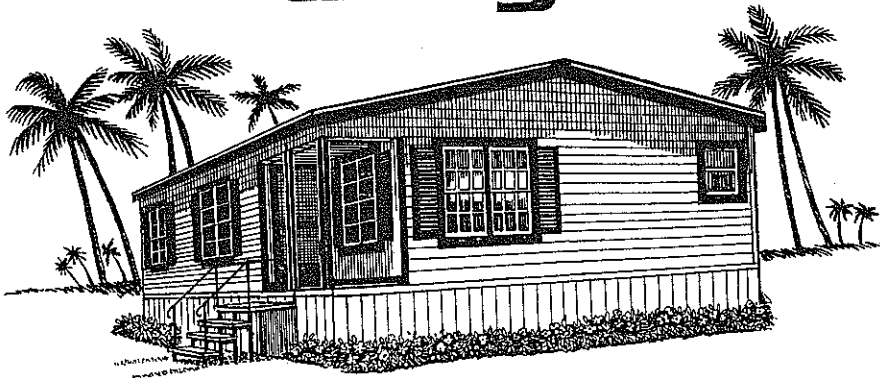
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general rule: assignments of future wages as security for a present debt do not constitute a lien within the meaning of the Bankruptcy Code. However, the court said this rule was not violated, and it enforced the assignment by the agent of his renewal commissions.

With respect to liens, it must be remembered that bankruptcy courts can sell property of a bankruptcy estate free and clear of all claims, interests and liens. Sometimes, litigation arises as to the scope and meaning of the relevant Code sections in the context of the sale of an insurance business, which includes the right to commissions. In this context, it has been held that the insurer had no right to recoupment. When a bankruptcy court sells free and clear of claims, that includes any claim to recoupment.

Licensure

Section 525(a) of the Code states that; governmental units may not deny, revoke, suspend, or refuse to renew a license...to, condition such a grant to, discriminate with respect to such a grant against...a person that is or has been a debtor under this title...solely because such bankrupt...has not paid a debt that is dischargeable in the case[.]

As applied, state departments of insurance cannot revoke an agent's license or refuse to issue one on the grounds that he has been or is in bankruptcy or upon the grounds that he was discharged from debt.

This provision is often called the "anti-discrimination provision" of the Code. Federal district courts can enjoin state departments of insurance from revoking or refusing to issue licenses on grounds inconsistent with § 525(a). Often the state regulators try to find some other ground to force the agent out. Courts respond with realism!

Conclusion

Maybe this is all pessimistic poppycock. Maybe Dr. Bull did not succeed in exorcizing my overly-bearish streak. Maybe not one word needs to be said about bankruptcy in the context of our soaring economy. Then again, the cautious and prudent agent would do well to think about ways to immunize renewal commissions from the claims of a trustee in bankruptcy and—at the same time - think about ways to protect renewal commissions from insure greed if bad times—an consequent bankruptcies—crash in upon us. ☐

Quinn is an Austin shareholder in the law firm of Sheinfeld, Maley & Kay. He litigates and testifies on insurance related problems and is currently the chair of the Insurance Section of the State Bar of Texas. He also is a Visiting Professor of Law at the University of Texas-Austin.