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EXEMPTION OF A DEBTOR'S INTEREST IN AN EMPLOYEE BENEFIT PLAN - a Follow-Up

By William J. Barrett *

No sooner was my article on Michigan's new exemption statute in print [Bankruptcy Law Newsletter, Vol. 1, No. 10] that a bankruptcy court in Texas[1] found portions of a similar statute preempted by ERISA. The Texas court held that a state cannot exempt from creditor execution a debtor's interest in a benefit plan subject to ERISA. To understand the Texas ruling, how it may apply to Michigan's statute, and the general confusion that exists in this entire area both before and after the Texas ruling, a history of the exemption of employee benefit plans is required.[2]

An understanding of the present state of the law starts with seeing how ERISA affected the ability of a creditor to reach ERISA qualified plan assets outside of the bankruptcy context. Section 206(d)(1) of ERISA [29 U.S.C. §1056(d)(1)] states that, "each pension plan shall provide that benefits provided under the plan may not be assigned or alienated." In the early years of ERISA a number of cases considered whether a creditor could attach or garnish benefits under a plan that complied with that provision. Although courts initially went both ways, the settled rule, and the rule in the 6th Circuit, is that creditors may not reach benefits under a benefit plan that complies with the non-alienation provision. General Motors Corp. v. Buha, 623 F.2d 455, 463 (1980); In re Gribben, 84 Bankr. 494 (Bankr. S.D. Ohio 1988). Thus, at least with respect to employee benefit plans subject to ERISA, in the non-bankruptcy setting the new Michigan exemption statute did not create an exemption that did not already exist under federal law.

The situation becomes much muddier once the debtor files for bankruptcy. Unless the ERISA plan qualifies as a spendthrift trust under state law (which is unlikely if the principal beneficiaries of the plan are the principals of the employer), then the debtor's interest in the plan will become property of the estate under §541(a) of the Bankruptcy Code.[3] Although §541(c)(2) of the Code states that, "a restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable non-bankruptcy law is enforceable in a case under this title.", the courts have consistently held that the "non-bankruptcy law" referenced in that section does not include ERISA. In re Brooks, 844 F.2d

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258, 261 (5th Cir. 1988); In re Reagan, 741 F.2d 95, 97 (5th Cir. 1984); In re Goff, 706 F.2d 574, 587 (5th Cir. 1983); Cf. In re Watkins, 95 Bankr. 483 (W.D. Mich. 1988) (J. Enslen).

Since in most cases a debtor's interest in a qualified benefit plan will become property of the estate, the debtor's only hope is to exempt the plan under §522 of the Code. If the debtor invokes the federal exemptions, then the debtor may only exempt his or her interest in the plan "to the extent reasonably necessary for the support of the debtor and any dependent." Bankruptcy Code §522(d)(10)(E). Since this exemption might only protect a small portion of the debtor's interest in the plan, the debtor in bankruptcy with substantial assets in an employee benefits plan will usually invoke the state exemptions.

Debtors relying on state exemptions have attempted to use §522(b)(2)(A) to protect their plans. Section 522(b)(2)(A) exempts, for the debtor electing the state exemptions, "any property that is exempt under Federal law other than subsection (d) of this section. . . ." Debtors have argued that "Federal law", as used in §522(b), includes ERISA. Since ERISA prohibits assignments and alienations of plan assets, debtors argued that their interest in a benefit plan is exempt under federal law. Although this argument makes logical sense, it has been consistently rejected by the courts. The courts reasoned that since Congress specifically recognized the existence of qualified plans in §522(d), it did not intend for ERISA to be included within the general reference to federal laws contained in §522(b). See, e.g., In re Daniel, 771 F.2d 1352, 1361 (9th Cir. 1985), cert. denied, 106 S. Ct. 1199; In re Lichstrahl, 750 F.2d 1488, 1491 (11th Cir. 1985). See In re La Fata, 41 Bankr. 842 (Bankr. E.D. Mich. 1984), aff'd.

Because of these interpretations of "Federal Law" as used in §522(b), the debtor's only hope was to look for an exemption under state law. Responding to this situation, states (such as Michigan and Texas) set out to create a new statutory exemption for employee benefit plans. All the Michigan and Texas exemption statutes do is preserve for the debtor in bankruptcy the same exemption that he would have had outside of bankruptcy since, in state court collection proceedings, ERISA exempts qualified benefits plans from execution.

At least in Texas, this attempt has failed. The Texas court [In re Dyke, 19 B.C.D. 105 (Bankr. S.D. Tex. 1989)] held that §514(a) of ERISA, which provides that ERISA "shall supersede any and all state laws insofar as they may now or hereafter relate to any employee benefit plan", preempts any state law exempting from execution an interest in a qualified plan. The court's analysis was long and convoluted -- the court in the end relying on precedents from other areas in holding that ERISA's preemption language should be read broadly. See Shaw v. Delta Airlines, 103 S. Ct. 2890 (1983).

The Dyke decision, if adopted by other courts, will lead to anomalous results. Debtors will be able to protect a major asset in the non-bankruptcy context, but may lose that asset if they file for bankruptcy. There appears no policy reason to support this distinction between the bankruptcy and non-bankruptcy settings. The real difficulty, however, does not lie in the Dyke decision itself, but rather in the case law that has

developed under §541(c)(2) and §522(b)(2)(A) of the Code. In excluding ERISA from "nonbankruptcy law" as used in §541(c)(2) and from "Federal law" as used in §522(b)(2)(A), and in interpreting §514(a) of ERISA broadly, the courts have doomed further decisions to the same illogical outcome as in the Dyke case.

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1. In re Dyke, 19 B.C.D. 105 (Bankr. S.D. Tex. 1989)

2. The Texas decision did not preempt states from exempting IRA's and other investment devices and benefit plans not covered by ERISA.

3. Conversely, if the debtor/plan beneficiary is a participant in a plan sponsored by a large employer and the plan has an independent trustee then §541(c)(2) will likely keep the debtor's interest in the plan out of his bankruptcy estate. See In re Watkins, 95 Bankr. 483 (W.D. Mich. 1988).

RECENT BANKRUPTCY DECISIONS

The following are summaries of recent decisions rendered by the United States Supreme Court, the Sixth Circuit Court of Appeals and federal district and bankruptcy courts in Michigan that address important issues of bankruptcy law and procedure. These summaries were prepared by Patrick E. Mears with the assistance of Larry A. Ver Merris.

United States v. Arnold, Case No. 88-1703 (6th Cir. July 3, 1989). The Chapter 12 debtors, husband and wife, filed their voluntary joint petition with the United States Bankruptcy Court for the Western District of Michigan on February 2, 1987. At that time, the Farmers Home Administration ("FmHA") held a partially secured claim against the debtors for the total sum of $273,947.28. The debtors' Chapter 12 plan proposed to cram down the FmHA's secured claim of $157,000 under 11 U.S.C. §1225(a)(5)(B) in the following manner:

> The plan submitted by the debtors proposed repayment of only a portion of the first two notes executed between the debtors and FmHA. The debtors proposed that the secured value be prorated between the first two notes according to the unpaid principal balance and accrued interest on each note. The payment on the allowed secured claim would approximate 83 percent of the total amount due on both these notes. After prorating the secured debt among the first two notes, the debtors proposed repayment at the contract rate of interest provided in the notes with full payment by the respective original due date of each note. With respect to the remaining indebtedness evidenced by the third, fourth, and fifth notes between debtors and FmHA, debtors proposed the same treatment for these amounts as for the general class of unsecured creditors.

Also, prior to the debtors' filing of their petition under Chapter 12, they had qualified for an "interest credit" under appli-

cable FmHA regulations. Pursuant to this interest credit, received in 1986, the contract rate of interest upon the first note executed (9 percent) was waived, and the debtors were paying only 1 percent interest on this note at the time of filing. The debtors proposed in their plan that they would continue to pay the 1 percent interest rate on the amount prorated to the first note until such time that FmHA, pursuant to periodic review conducted in connection with the interest credit program, determined that the financial condition of the debtors had improved to the extent that they no longer qualified for the interest credit. Should this occur, debtors maintained that the interest rate should then revert to the 9 percent contract rate. The interest rate on the amount prorated to the second note would remain the contract rate throughout the plan. The 1 percent interest credit rate on the first note and the 5 percent rate on the second note are less than FmHA's current market rates.

FmHA objected to confirmation of the plan since it failed to pay to FmHA the present value of its secured claim. Specifically, FmHA alleged that the plan did not propose to pay a current market rate of interest on this claim. The bankruptcy court confirmed the plan on the ground that the debtors could properly pay the lesser of the contract rate of interest and the market rate, citing the Sixth Circuit's earlier decision of In re Colegrove, 771 F.2d 119 (6th Cir. 1985). On appeal, the district court reversed, and held that the FmHA must be paid the current market rate of interest under 11 U.S.C. § 1225(a)(5)(B). The debtors then appealed to the Sixth Circuit which affirmed the district court's decision.

On appeal, the Sixth Circuit framed the issue before it as follows:

> . . . whether the interest rate to which the FmHA is entitled on its allowed secured claim is the current market rate, the contract rate, or the lesser of the two.

The Sixth Circuit found its Colegrove decision to be inapposite and "limited to its facts." In Colegrove, a Chapter 13 case, the issue before the Court was what rate of interest should be paid on home mortgage arrearages under 11 U.S.C. § 1322(b)(2). The panel here cited an earlier decision, Memphis Bank & Trust Co. v. Whitman, 692 F.2d 427 (6th Cir. 1982), as controlling. Memphis Bank, held that a secured claim crammed down under 11 U.S.C. §1325(a)(5)(B) must be paid a current market rate of interest in order for the plan to be confirmed. Citing with approval Bankruptcy Judge James Gregg's recent decision of In re Kain, 86 Bankr. 506 (Bankr. W.D. Mich. 1988), the Sixth Circuit summarized its holding as follows:

> . . . where a "cramdown" occurs under section 1225(a)(5)(B) and a creditor is forced to write-down a portion of its note, a creditor is entitled to receive its current market rate on the "new loan." In our view, Colegrove is clearly distinguishable.

Gosch v. Burns, Case No. 88-CV-72353 (E.D. Mich. June 15, 1989). This case involved an appeal from the decision of Bankruptcy Judge Steven Rhodes imposing preference liability upon an insider guarantor. That decision, entitled In re Finn, is reported at

6 Bankr. 902 (Bankr. E.D. Mich. 1988). In this case, the Chapter 7 debtor had made regular monthly payments on certain long-term debt she owed to a secured creditor, a credit union, during the year prior to bankruptcy. Repayment of this debt had been personally guaranteed by the debtor's brother. After the debtor commenced her bankruptcy case, the trustee initiated an adversary proceeding against the guarantor to recover the amount of these payments as preferential. After a hearing conducted on stipulated facts, Bankruptcy Judge Rhodes granted the trustee's motion for summary judgment. This appeal by the guarantor followed.

In her opinion affirming Judge Rhodes decision, District Judge Hackett first rejected the guarantor's argument that, even though technically an "insider," he had no control over the debtor's disposition of funds. The guarantor therefore argued that the court should limit his liability on equitable grounds. Judge Hackett declared that even though the guarantor may have held no such power, the "potential for the creditor to benefit from the debtor's payments remains the same in both situations since a contingent debt is discharged by the payments. [Citation omitted] That [the guarantor] had no control over which debts were paid by the Debtor, or that he was unaware of her financial situation during the year preceding the Debtor's bankruptcy, are all risks he assumed as a guarantor of the debt."

Judge Hackett then rejected as "irrelevant" the guarantor's argument that the debtor's reaffirmation of the debt to the secured creditor in her Chapter 7 case negated the guarantor's preference liability. Finally, Judge Hackett dismissed the claim that the regular installment payments made to the credit union were exempt as transfers made in the "ordinary course of business" under 11 U.S.C. § 547(c)(2). Judge Hackett concluded that the debtor's long-term installment debt did not qualify for this defense since consumer debtors, "like the Debtor here, do not in general incur long-term installment debt in the ordinary course of their financial affairs."

Longo v. Glime, Case No. 86-CV-73842 (E.D. Mich. July 13, 1989). The plaintiff in this civil action was a prepetition creditor of the defendant who had filed a voluntary Chapter 7 petition in July, 1987. The plaintiff was listed on the debtor's schedule as the holder of an unsecured claim. The plaintiff did not commence an adversary proceeding in the Chapter 7 case for the determination of the nondischargeability of his claim against the debtor and, accordingly, this claim was discharged when debtor received his general discharge order in November, 1987. In the meantime, on September 12, 1986, plaintiff had commenced this civil action against the debtor, an auction company and two individuals for a judgment on this claim.

In this civil action, the debtor moved for summary judgment dismissing plaintiff's claim against him on the ground that the debt had been discharged in the bankruptcy case. This motion was granted by the federal district court per Judge Lawrence Zatkoff. In the court's opinion, the plaintiff's argument that he was required to obtain a judgment against debtor to collect on a surety bond was rejected. Judge Zatkoff noted that the plaintiff was free to commence his action against the surety since that company's

liability under its bond would not be affected by the debtor's general discharge.

Hunnicutt v. Wellever, Adversary Proceeding No. 88-0001 (Bankr. W.D. Mich. July 25, 1989). In this adversary proceeding to determine the dischargeability of a debt under section 523(a)(6) of the Bankruptcy Code, the plaintiff-creditor moved for partial summary judgment against the individual Chapter 7 debtor on the ground that a jury verdict and judgment for $45,025.75 rendered by an Oklahoma state court against the debtor should be given collateral estoppel effect by the Bankruptcy Court. The debtor was found by the jury to have been guilty of malicious prosecution vis a vis the plaintiff. The plaintiff-creditor furnished to Bankruptcy Judge Laurence Howard with her motion copies of the state court complaint, jury instructions, jury verdict, and the order setting forth the jury verdict. In his opinion granting the plaintiff's motion, Judge Howard noted that it was "clear from the jury instructions and the verdict that the issue of willful and malicious conduct was not merely 'actually litigated' and 'necessary' to the judgment, but rather that it was in fact the central and sole issue before the jury and the main question they had to confront in deciding to hold for the plaintiff." Judge Howard stated that, in order to grant the motion, it was not necessary to review the entire record of the state court litigation. Rather, it was "sufficient for the bankruptcy court to look at enough of the state court records to assure itself that the issues it faces in a nondischargeability proceeding were actually litigated in state court and were necessary to the state court judgment." Finally, Judge Howard held that "the proper standard of proof under [11 U.S.C. § 523(a)(6)] should be the preponderance of the evidence."

Sweeney v. Walter E. Heller & Co., et al., Adversary Proceeding No. 81-1496 (Bankr. W.D. Mich. July 18, 1989). This adversary proceeding was commenced in the bankruptcy case of American Plastics Corporation (Case No. NK 80-00928) which has been pending since April 2, 1980. In this matter, the Chapter 7 trustee filed a motion to set aside a settlement agreement executed by him, the Internal Revenue Service, and others and approved by bankruptcy court order entered in July, 1986. This agreement resolved a dispute regarding the priority of liens in the debtor's accounts and provided for distribution of the proceeds of these accounts to competing lien claimants. Sometime in 1988, however, the trustee filed the motion to annul the settlement agreement and to obtain a return of the cash proceeds pursuant to 11 U.S.C. § 724(b). In his opinion denying the trustee's motion, Bankruptcy Judge David Nims stated that no grounds exist to set aside the settlement agreement, viz., there was no evidence of mutual mistake of fact, fraud, or unconscionable advantage. The trustee's argument of mutual mistake of fact was rejected by Judge Nims since the trustee's counsel knew or should have known all of the relevant facts at the time his client signed the settlement agreement.

In re Micro-Time Management Systems, Inc., Case No. 88-01181 (Bankr. E.D. Mich. June 23, 1989). In this Chapter 11 case, a trustee was appointed to operate the debtor's business and retained an accounting firm to assist him in his duties as trustee. This firm (of which the trustee was a partner) thereafter filed an

application for payment of professional fees along with the trustee. The United States Trustee and an individual creditor objected to these two fee applications. The basis for these objections was that the trustee and the accounting firm failed to disclose that another company in which the trustee was a principal provided consulting services to Comerica Bank, a major creditor of the debtor, and had not previously disclosed this potential conflict of interest to the bankruptcy court.

In an exhaustively researched opinion authored by Bankruptcy Judge Steven Rhodes, he held that the trustee and his accounting firm were not disinterested persons under 11 U.S.C. §101(13) on account of this conflict of interest and that this conflict should have been previously disclosed to the court. Consequently, Judge Rhodes vacated the orders appointing the trustee and retaining the accounting firm and denied their fee applications.

EDITOR'S NOTEBOOK

With this edition, the pen has now been passed from Patrick E. Mears to me as Editor of the Newsletter for the coming year. On behalf of the Bankruptcy Section of the Federal Bar Association as well as Newsletter readers, I would like to express my grateful appreciation to Pat for all his work in helping to get the Newsletter off the ground and volunteering to act as its initial editor. Pat has done an outstanding job in this endeavor, and we would hope that you would all take a moment to compliment him for his fine efforts in helping to get this publication started. Pat has graciously agreed to continue to summarize recent bankruptcy cases for the Newsletter.

Congratulations are also in order for Ellen G. Ritteman, who is now the Assistant U.S. Trustee for the Western District of Michigan. She was formerly the acting U.S. Trustee of this District.

With this edition you may notice a slight change in the format the Newsletter has taken. This is a consequence of the use of software different from that used by Mr. Mears' office. Every attempt will be made to make future editions as homogeneous as possible.

I have quickly found that one of the most difficult jobs as editor is to find persons to write lead articles and then get them in on a timely basis. If any of you is interested in writing on a particular topic, please contact me. If you have an IBM-compatible machine, articles may be forwarded in WordPerfect 5.0 on a 5-1/4 inch floppy disk.

In Borg-Warner Acceptance Corp v Mich Dep't of State, the Michigan Supreme Court recently decided that where the defendant-Department of State failed to discover a secured creditor during a financing statement search it had made for the plaintiff-finance company, that the Michigan Department of State was not liable to the plaintiff on a breach of contract theory. This decision reversed the Michigan Court of Appeals and may mean that you rely on such financing statement searches at your peril.

Finally, ICLE is conducting a seminar entitled, "Bankruptcy: How to Represent Your Client in Chapter 7 and in Chapter 11" in Grand Rapids on October 12, 1989 and in Southfield on October 25, 1989. For more information, please contact ICLE at (313) 764-0533.

Larry A. Ver Merris

MEMORANDUM REGARDING ALLOWANCE OF COMPENSATION AND REIMBURSEMENT OF EXPENSES FOR COURT-APPOINTED PROFESSIONALS

As Adopted by the United States Bankruptcy Court for the Western District of Michigan on August 2, 1989

Recently, parties in interest have been lodging more frequent objections to applications for the allowance of compensation and reimbursement of expenses. In an attempt to reduce the number of these objections, the court has determined that it is in the interests of all debtors, creditors, their respective attorneys, and other parties in interest, including the United States Trustee, that the following general guidelines respecting the format of fee applications be established and published.

1. Professional persons approved and appointed by the United States Bankruptcy Court for the Western District of Michigan, pursuant to 11 U.S.C. §§327(a) and 1103(a), and Bankruptcy Rule 2014, are required to comply with the standards for applications for compensation of professional persons as set forth in 11 U.S.C. §§328 and 330(a)(1) and Bankruptcy Rule 2016. The burden of proof regarding all fee applications is imposed upon the applicant.

2. An application must itemize each activity, its date, the professional who performed the work, a description of both the nature and substance of the work and the time expended thereon. Records providing no explanation of activities performed will be deemed inadequate and therefore non-compensable.

3. In order for time spent on activities such as court appearances, preparation for court appearances, conferences, telephone calls, drafting documents, and research to be compensable, the nature and purpose of the activity must be noted. Time entries for telephone calls must list the person with whom the applicant spoke and give a brief explanation of the conversation. Time entries for letters must state the addressee and give a brief explanation of the letter's contents. Time entries for documents must specify the document involved. Time entries for legal research must describe the matter or proceeding researched.

4. Applicants must not attempt to circumvent minimum time requirements or any of the detail requirements by "lumping" or "bunching" a number of activities into a single entry. Each type of service must be listed with a corresponding specific time allotment.

5. Time entries with unexplained abbreviations are noncompensable. Where computer time sheets are submitted to substantiate entries, a code key must be supplied, or the application will not be considered. In more complex petitions, a glossary of persons involved may be helpful.

6. The application must state the amount of any retainer paid, as well as the date of each previous application, the amount of compensation and

expenses requested, the amount of compensation and expenses approved, the date of approval, and the amount received. The application must also indicate the total hours charged and give a summary of the hours and hourly rate charged by each professional.

7. If more than one professional has charged time for activities such as intra-office conferences or joint court appearances, the applicant must explain the need for each professional's participation in the activity.

8. All time listed must represent the actual time required to perform the activity and should be stated in tenths of an hour. "Rounding up" of time or minimum time increments of .25 hour are not permitted.

9. The rates charged must be commensurate with the level of skill required for a particular task; for example, attorney rates or paralegal rates may not be charged for nonlegal work, such as copying or delivering documents, preparing or filing proofs of service, or for trustee duties generally performed without the assistance of an attorney. When paralegals are utilized to perform services for an estate, they may be compensated as paraprofessionals and not reimbursed as overhead expenses.

10. No fees will be allowed for general research on law well known to practitioners in the area of law involved.

11. Reasonable time spent in preparing an application for compensation may be compensable.

12. The court will consider whether tasks were performed within a reasonable number of hours and whether the requested hourly rate is reasonable based upon the customary rate charged by experienced practitioners.

13. The court will not allow compensation for services which do not benefit the debtor estate; for example, fees for reading the work product of another attorney simply as a matter of interest or performing legal services mainly beneficial to the debtor, or the debtor's principals.

14. An application for reimbursement of expenses must list each expense, its date, and a description of the nature and purpose of the expense. For example, requests for mileage must include the date, destination, miles, per mile rate and the reason for the trip. Professionals should utilize the most economical method for necessary expenses; for example, coach air fare accommodations and commercial firm duplication for large numbers of copies. Courier service, express mail service and FAX transmissions should not be used routinely but, if used, should be as a result of justifiable reasons including time constraints.

15. In Chapter 13 cases, the court may approve compensation of a debtor's attorney in an amount not to exceed $1,000 for services rendered through the time of confirmation, without the necessity of filing an itemized statement of services rendered, provided an agreement is filed with the court which sets forth the agreed-upon fee for such pre-confirmation services. The required agreement shall be executed by the debtor and the debtor's attorney. If services with a reasonable value in excess of $1,000 are performed, and

documented by the filing of an itemized fee application as required herein, the court may award a fee in excess of $1,000 in Chapter 13 cases.

16. The court may consider petitions for fees and expenses on a notice and objection basis as authorized by the Local Bankruptcy Rules for the Bankruptcy Court of the Western District of Michigan. The court may, sua sponte and without notice of hearing, or upon the motion of any party in interest or the United States Trustee after notice and hearing, order that payment of all, or some portion, of allowed interim fees be withheld for a particular period of time. Whenever payment of an applicant's fee has been deferred by the court without a hearing, that applicant may file at any time a motion to rescind or modify deferral. Motions to rescind or modify deferral shall be set for hearing.

17. Attorneys should keep in mind that in most cases the reasonableness of the work done and the fee charged will depend upon the results attained. A part of the service to be performed by an attorney is to estimate, as to each prospective proceeding, the probability of success, the amount to be realized and the overall benefit to creditors.

This court will consider applications for allowance of compensation and reimbursement of expenses which comport with the guidelines set forth in this memorandum.

LOCAL BANKRUPTCY STATISTICS

The following is a summary of the number of bankruptcy cases commenced in the United States Bankruptcy Court for the Western District of Michigan during the period from January 1, 1989 through July 31, 1989. These filings are compared to those made during that same period 1 year ago.

	1/1/89-7/31/89	1/1/88-7/31/88
Chapter 7	1,940	1,627
Chapter 11	61	60
Chapter 12	7	19
Chapter 13	711	669

STEERING COMMITTEE MEETING MINUTES

A meeting previously scheduled for July 28, 1989 was canceled. The next meeting of the Steering Committee has yet to be scheduled.