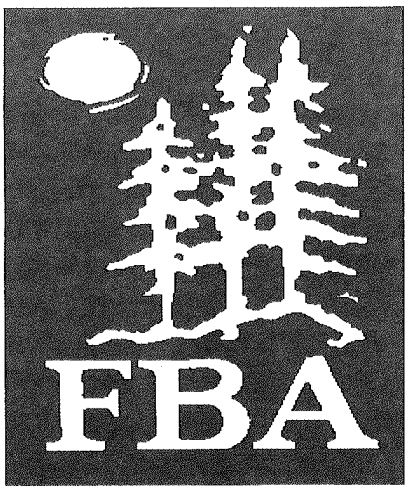

BANKRUPTCY LAW NEWSLETTER

Published by the Federal Bar Association
Western District of Michigan Chapter

January, 1998

ARE PENSION FUNDS PROTECTED FROM CREDITORS?

By Eric S. Richards*

In a rather lengthy opinion, Judge Rhodes recently held that a Debtor's beneficial interest in an annuity savings plan administered by a government employer should not be excluded from the Chapter 7 estate under 11 U.S.C. §541(c)(2). Judge Rhodes further held that the Debtor's claimed exemption of this interest should be disallowed because the full amount was not necessary to pay the Debtor's support as required under 11 U.S.C. §522(d)(10)(E). See In re Jesse Douglas Dunn, Case No. 96-52985-R, ___ B.R.___, 1997 WL 738371 (Bankr. E.D. Mich. Nov. 12, 1997). On December 22, 1997, Judge Rhodes issued a supplemental opinion reaffirming his previous ruling against the Debtor. These opinions are scheduled for publication and Judge Rhodes has specifically requested that they be featured in the FBA Bankruptcy Law Newsletter. At first blush, this would seem to portend ill-tidings for debtors' counsel. However, as explained below, the precedential significance of these rulings can be limited by careful attention to the facts.

BACKGROUND. At the time he filed his Chapter 7 plan in 1996, the Debtor was 50 years old and had approximately $25,000 in unsecured debts. He was employed by the City of Detroit and he participated in two separate retirement plans. One plan was funded exclusively

by the City, and the Chapter 7 Trustee conceded that this plan was not a part of the bankruptcy estate. In addition, the Debtor had approximately $105,000 in a separate "Annuity Savings Plan" (the "Plan"). The Plan was also administered by the City, but was funded entirely by voluntary contributions from the Debtor. The Debtor disclosed his interest in the Plan, but claimed an exemption for the entire amount pursuant to Bankruptcy Code §522(d)(10)(E). The trustee objected to the exemption and the Debtor subsequently amended his Chapter 7 schedules to exclude his interest in his annuity savings plan under Bankruptcy Code §541(c)(2). The court's opinion addressed two issues: (1) whether the Debtor's interest in the annuity savings plan was property of the estate; and (2) whether the Debtor's claimed exemption of that interest should be allowed.

ISSUE 1 -- Property of the Estate. In arguing that his pension plan should not be included in the bankruptcy estate, the Debtor relied on Bankruptcy Code §541(c)(2) which provides, "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." 11 U.S.C. §541(c)(2). Relying on the Supreme Court's decision in Patterson v. Shumate, 504 U.S. 753, 758; 112 S. Ct. 224, 226 (1992), Judge Rhodes adopted a three part test to determine whether the funds in the Plan should be excluded from the estate. First, the court must determine whether the Debtor's interest in the Plan is a beneficial interest in a "trust." Second, the court must decide whether there is a restriction on the transfer of the Debtor's interest in the plan. Third, the court must determine that the restriction is enforceable under either federal or state law. Judge Rhodes concluded that the Debtor's interest in the Plan was a trust, and that it did have a restriction on transfer. Thus, the first two requirements of the test were satisfied. Accordingly, the third factor was the decisive issue in this case, i.e., whether the restriction was enforceable under either federal or state law. If so, the Plan funds would be excluded from the Debtor's Chapter 7 estate pursuant to §541(c)(2).

A. Plan Restrictions Unenforceable Under Federal Law. The Plan contained fairly standard restrictions prohibiting assignment of benefits. However, Judge Rhodes held that the Plan was not subject to ERISA because it was a governmental plan. See Slip op. at 8 (citing ERISA, 29 U.S.C. §§1002(32), 1003; also citing Shumate, 504 U.S. at 762-63; 112 S. Ct. at 224). Having found that the Plan was not governed by ERISA, Judge Rhodes next considered whether the Plan was a qualified trust under §401(a)(13)(A) of the Internal Revenue Code; and, if so, whether I.R.C. §401(a) provides for the enforcement of a restriction on the transfer of trust funds. Judge Rhodes identified a split of authority on the issue. The majority of cases have held that an anti-alienation clause which is sufficient to qualify under I.R.C. §401(a) does not operate to exclude a plan from the bankruptcy estate unless the plan is also "ERISA qualified" or qualifies as a spendthrift trust under state law. See In re Kellogg, 179 B.R. 379, 388 (Bankr. D. Mass. 1995); In re Acosta, 182 B.R. 561 (N.D. Cal. 1994); Whitwer, 148

B.R. 930, 936-37 (Bankr. C.D. Cal. 1992), aff'd, 163 B.R. 614 (9th Cir. BAP 1994). These courts reasoned that I.R.C. §401(a) did not create any substantive rights that were enforceable by a beneficiary; and thus, qualification under the Internal Revenue Code alone was not sufficient to exclude the plan from the property of the estate under the Bankruptcy Code.

Judge Rhodes agreed with the majority view and rejected those cases which had held that a plan was not property of the estate based solely on qualification under I.R.C. §401(a). See, e.g., In re Copulos, 210 B.R. 61, 64 (Bankr. D.N.J. 1997); In re Leamon, 121 B.R. 974 (Bankr E.D. Tenn. 1990) (qualification under I.R.C. §401(a) meets the requirements of Bankruptcy Code §541(c)(2), even though the plan is not subject to ERISA). In rejecting these cases, Judge Rhodes concluded that qualification under the I.R.C. alone is not sufficient to determine the transfer restriction is enforceable under non-bankruptcy law. In effect, the court held that being tax-qualified is not the same as being ERISA-qualified for purposes of determining whether a pension plan should be included in a bankruptcy estate. Accordingly, because the Plan in this case was not qualified under ERISA, the transfer restriction was not enforceable under any federal non-bankruptcy law.

B. Plan Restrictions Unenforceable Under State Law. Having determined that the Plan restrictions could not be enforced under federal law, the court next focused on the status of the Plan under Michigan law. Judge Rhodes concluded that the transfer restrictions in the Plan did not qualify as a "spend-thrift trust" under Michigan law, because there was virtually no limit on the Debtor's ability to access the Plan funds. Judge Rhodes noted that on at least two occasions, the Debtor had used his interest in the Plan as collateral for loans from his Employee Credit Union. Under the terms of the loan agreements, the Credit Union was authorized was to take payment on the loans directly from the Plan. The practical result was that the Debtor could obtain distributions of Plan funds at any time, regardless of the Plan provisions regarding distribution. Moreover, the Plan was funded entirely by voluntary employee contributions. Under these circumstances, Judge Rhodes concluded that the plan was "self-settled" by its beneficiaries; and thus, the Plan was not a valid spendthrift trust under Michigan law.

This portion of the original ruling was emphasized in a supplemental opinion issued by Judge Rhodes on December 22, 1997. The purpose of the supplemental opinion was to address a Michigan Supreme court case that had not been raised by the parties. See Wyrzykowski v. City of Hamtramck, 324 Mich. 731, 37 N.W.2d 686 (1949). In that case, the Michigan Supreme Court had held that pension benefits provided by the City of Hamtramck were not subject to garnishment by the creditors of City employees. Judge Rhodes distinguished this case on the grounds that Hamtramck plan was funded through mandatory employee contributions which are the functional equivalent of employer contributions. Thus, the plan at issue in Wyrzykowski was not a self-settled trust; whereas the

Debtor's Annuity Savings Plan was entirely funded by voluntary employee contributions, thereby making it a "self-settled" trust. In his supplemental opinion, Judge Rhodes emphasized the underlying policy concern at issue, i.e., "Michigan law does not permit a debtor to shield his assets from his creditors simply by depositing them into a trust fund established for that purpose." Supplemental Opinion at p.4. Accordingly, Judge Rhodes reaffirmed his prior holding that the transfer restriction in the Plan was not enforceable under either federal or state law. Therefore the Plan was not excluded from property of the bankruptcy estate under Bankruptcy Code §541(c)(2).

ISSUE 2 -- Hardship Exemption. Having established that the Plan should be included in the Chapter 7 estate, the next issue was whether the Debtor's interest in the Plan should be deemed exempt "to the extent reasonably necessary for the support of the Debtor and any dependent of the Debtor, . . ." See 11 U.S.C. §522(d)(10)(E). Judge Rhodes found that the claimed exemption was presumptively valid, and that the Trustee, as the objecting party, had the burden of rebutting this presumption. The court considered the following eleven factors to determine whether the funds were reasonably necessary for the support of the Debtor and his dependents:

(1) Debtor's present and anticipated living expenses; (2) Debtor's present and anticipated income from all sources; (3) age of the Debtor and dependents; (4) health of the Debtor and dependents; (5) Debtor's ability to work and earn a living; (6) Debtor's job skills, training, and education; (7) Debtor's other assets, including exempt assets; (8) liquidity of other assets; (9) Debtor's ability to save for retirement; (10) special needs of the Debtor and dependents; and (11) Debtor's financial obligations, e.g. alimony or support payments.

In re Dunn, slip op. at 21, 1997 WL 738371 (citing In re Mann, 201 B.R. 910, 915 (Bankr. E.D. Mich. 1996)). In analyzing these factors, Judge Rhodes noted that the Debtor was currently employed and that he still had at least 15 more years of employment before he reached the normal retirement age. Most importantly, the Debtor had over $105,000 vested in the Plan, which greatly exceeded his total unsecured debt of $25,000, plus the estimated $10,000 in administrative fees. Thus, there were sufficient funds in the Plan to pay off all of the unsecured creditors, all the administrative fees, and still leave a substantial amount to provide for the Debtor's retirement. Under these circumstances, Judge Rhodes concluded that the Debtor did not need all of the Plan funds for his support and therefore it did not qualify for the exemption claimed under §522(d)(10)(E).

ANALYSIS. Judge Rhodes' opinion would seem to be a powerful weapon in the hands of creditors seeking to obtain assets in a debtor's pension plan. However, upon closer examination, there are several key factors which debtor's counsel could use to limit the scope of the holding in this case. First, Judge Rhodes held that the Plan was not ERISA qualified because it was a

plan for government employees. Thus, the Dunn case can be easily distinguished from cases involving a private pension plan (assuming that such private plan was otherwise ERISA qualified). Second, the court concluded that the Plan did not qualify as "spendthrift trust" under Michigan law because the Debtor could borrow against the Plan through his Employee Credit Union. The Dunn case can be distinguished from those cases in which the employee's rights to borrow against their pension funds are limited. Third, Judge Rhodes held that the Plan was a "self-settled trust" because it was funded entirely through voluntary employee contributions. This conclusion was reinforced in the supplemental opinion. Thus, the Dunn case can be distinguished where the debtor's pension plan is funded through mandatory employee contributions, or funded solely by the employer, or perhaps even in cases where there are voluntary employee contributions with mandatory matching by the employer. Under any of these circumstances, debtor's counsel can argue that the plan funds should be excluded from the estate under §541(c)(2).

Finally, it appears that the size of the Debtor's interest in the Plan relative to the total amount of the debt was a decisive factor in Judge Rhodes' decision to disallow the exemption claimed under §522(d)(10)(E). As is often the case with a multi-factor test, the greater the number of factors, the wider the latitude for a court to reach a decision which it deems as ultimately just and equitable. In this case, it is apparent that Judge Rhodes believed that the Debtor could pay all of his creditors and still have sufficient funds for his retirement which was still several years off. The equities in the case would certainly have been different if the debtor had been an elderly retiree who was solely dependent on his pension benefits for survival. Under these circumstances, it is more likely that the court would find that the debtor qualified for a hardship exemption under §522(d)(10)(E).

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*Mr. Richards previously served as the law clerk to the Honorable James D. Gregg, United States Bankruptcy Judge. Mr. Richards recently joined the firm of Mika, Meyers, Beckett & Jones, P.L.C. where he practices in the areas of commercial litigation and bankruptcy.

****MENTORING LIST****

If anyone wants to be on a "Mentoring List" to answer questions from attorneys who are unfamiliar with bankruptcy law or practice, please contact either Robb Wardrop at 616-459-1225 or Peter Teholiz at 517-886-7176.

FEDERAL BAR ASSOCIATION BANKRUPTCY SECTION STEERING COMMITTEE MINUTES, JAN. 16 1998

Present: Tim Hillegonds, Hal Nelson, Steve Rayman, Eric Richards, Brett Rodgers, Tom Sarb, Peter Teholiz, Robb Wardrop, Norm Witte, Bob Wright, Tim Curtin, David Andersen.

ELECTION RESULTS: The committee welcomed Eric Richards as the newest member. Mr. Richards recently joined the law firm of Mika, Meyers, Beckett & Jones, PLC where he practices in the areas of bankruptcy and commercial litigation.

DEBTOR'S BAR COMMITTEE: David Andersen appeared on behalf of the Debtor's Bar Committee. According to Mr. Andersen, Judge Gregg has recently observed that the debtor's bar in the Western District of Michigan compared favorably with attorneys in other jurisdictions where Judge Gregg had recently served as a visiting judge. The Debtor's Bar Committee is currently considering various proposals before Congress to establish fee guidelines in consumer debtor cases. The Debtor's Bar Committee is also considering a proposal to increase the current $1,000 limit on post-petition borrowing in Chapter 13 cases.

GRAND RAPIDS BAR ASSOCIATION SEMINAR - APRIL, 1998. Bob Wright and David Andersen are working on this seminar.

BANKRUPTCY APPELLATE PANEL REPORT: Tim Curtin reported that the United States District Judges in the Eastern District of Michigan had recently rejected the proposed formation of a Bankruptcy Appellate Panel in that district. Although no final decision has yet been made, it appears that the District Judges within the Western District are also opposed to the creation of a BAP.

SUMMER SEMINAR REPORT: Peter Teholiz reported that this summer's annual FBA Bankruptcy Seminar will be held July 30 though August 1, 1998 at the Park Place Hotel in Traverse City, Michigan. The featured speaker will be Michigan Supreme Court Chief Justice Conrad Mallett. This summer's program will emphasize consumer bankruptcy issues. The Steering Committee agreed to offer a $50 discount on the seminar fee for paralegals.

OLD BUSINESS: Robb Wardrop alerted the Steering Committee to the potential for conflicts of interest and other ethical considerations that may arise when acting as a "mentor" to a bankruptcy attorney.

NEW BUSINESS: The Chair raised the possibility of compiling and publishing a summary of opinions issued by the Bankruptcy Court for the Western District of Michigan. This led to a general discussion of electronic filing and the availability of electronic information from the Bankruptcy Court. Messrs. Richards and Wright of the Technology Committee will examine these issues and report back to the Steering Committee.

There being no further business, the meeting was adjourned.

Eric S. Richards, Recorder.

LOCAL BANKRUPTCY STATISTICS

CHAPTER	DECEMBER 1997	YEAR END - 1997
Chapter 7	608	8,167
Chapter 11	2	72
Chapter 12	1	13
Chapter 13	218	2,995
TOTALS	829	11,247

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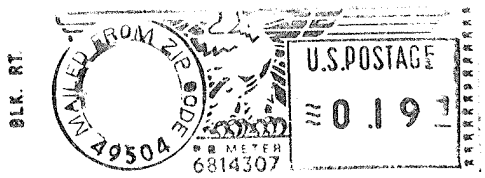

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