Exemptions In Bankruptcy After BAPA 2005

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Exemptions vs. Exclusions

- Exempt Property - § 522
  - Technically In the Debtor's Estate, but…
  - Exempt from Attachment or Liquidation
- Exclusions - § 541
  - Certain Property Not Even Included in Estate
  - Debtor Lacks Sufficient Possessory Interest For the Property to Count as His

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Exemptions Are In Addition to § 541 Exclusions. A debtor's right to exempt property is in addition to his right to claim an exclusion under § 541. Examples of property excluded under § 541 are:

- ERISA. A debtor's ERISA funds will be excluded from the estate under § 541 in most cases in any event. See *Patterson v. Shumate*, 504 U.S. 753, 112 S.Ct. 2242 (1992); *Guidry v. Sheet Metal Workers Pension Fund*, 493 U.S. 365, 110 S.Ct. 680 (1990).

- Non-Self-Settled Spendthrift Trust Interests. A debtor's interest in spendthrift trusts settled by third persons for his benefit are generally exempt. See cases cited supra.

- Limited Powers of Appointment. See § 541(b)(1) and related case law, cited elsewhere in this outline.

Combined Effect of Exemptions & Exclusions – Debtor Can Keep Lots! Consequently, in many cases, the combined effect of exemptions and exclusions is that a debtor can keep a lot, particularly if the debtor is eligible to claim the liberal exemptions that are available in some states, such as Florida and Texas.

In light of this legal reality, there is an old Texas adage that applies (at least pre-BAPA) in liberal exemption states: "Make sure you go bankrupt before you go broke."

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New Exclusion – Education Funds
(IRC §§ 529(b)(1)(A), 530(b)(1))

- Funds Contributed 365-720 Days Pre-Petition:
  - $5,000 Excluded
- Contribution 721 Days or More Pre-Petition:
  - Unlimited Exclusion
- Contributions Must:
  - Be for Debtor's Children or Grandchildren
    - "Step" Descendants and Adoptees OK, Too
    - Foster Children Also OK in Many Cases
  - Not Exceed IRC Contribution Limits
  - In Case of 530s, Not Be Pledged as Security

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New Exclusion – IRC §§ 529, 530 Education Savings. Congress added awkwardly phrased provisions to exclude from the debtor's estate certain of his contributions to an Internal Revenue Code ("IRC") § 529(b)(1)(A) plan and an IRC § 530(b)(1) education IRA. See 11 U.S.C. §§ 541(b)(5), 541(b)(6).

Qualifying for the Exclusion. To qualify for the exclusion, the contributions must:

- Be contributed "not later than 365 days before" the debtor's petition date. 11 U.S.C. §§ 541(b)(5), 541(b)(6).
- Be for the debtor's children, grandchildren, step-children or step-grandchildren. Id.
  - Adoptees and many foster children are also eligible beneficiaries. 11 U.S.C. § 541(e).
- Not exceed the contribution limits set under IRC §§ 529(b)(7) (for 529 plans) or 4973(e) (for education IRAs). 11 U.S.C. §§ 541(b)(5), 541(b)(6).

Additionally, funds contributed to education IRAs must not pledged as security. See 11 U.S.C. § 541(b)(5)(B)(i).

Time-Varied Amount of Exclusion. If the contributions were made at least 365 days pre-petition but less than 720 days pre-petition, the exclusion is capped at $5,000. 11 U.S.C. §§ 541(b)(5)(C), 541(b)(6)(C). If the contributions were more than 720 days pre-petition, then there is no limit to the exclusion, except for the limit inherent in the contribution limits set by the IRC.

Disclosure of Debtor's Plan Interest. A debtor must now automatically disclose to the court any interest he has in an IRC 529 plan or an Education IRA. 11 U.S.C. § 521(c).

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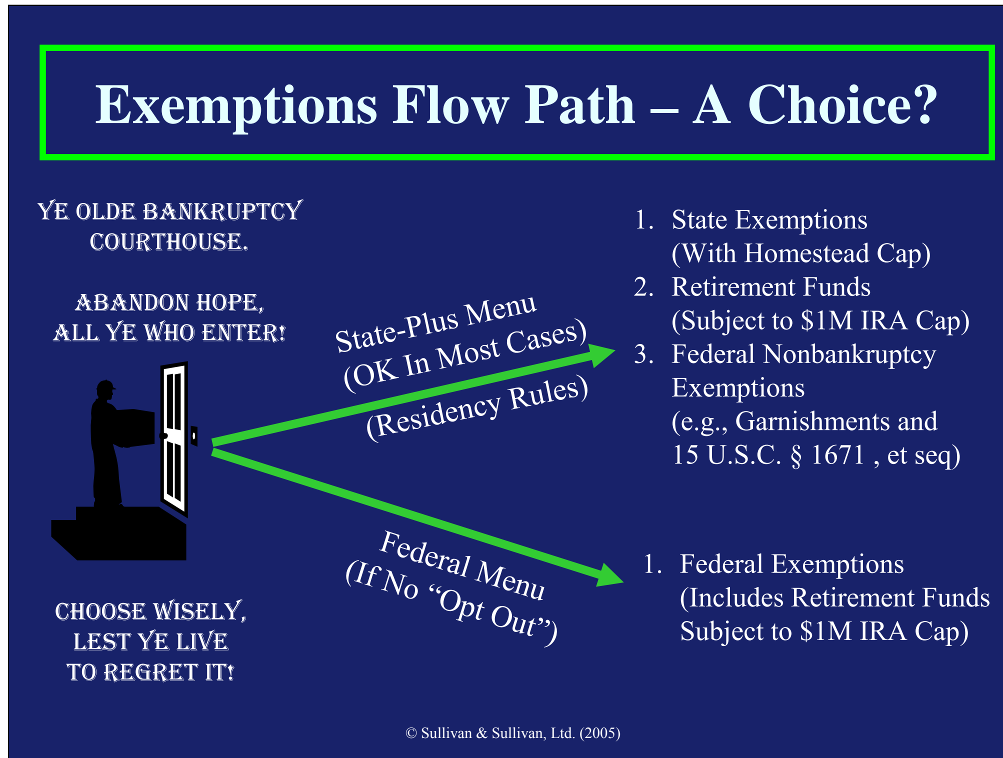

<u>Sec. 522 & Exemptions.</u> 11 U.S.C. § 522(b) allows debtors to "exempt from property of the estate" various enumerated assets, "[n]otwithstanding section 541." Hence, exempt property is also beyond the reach of the debtor's bankruptcy estate.

<u>"State vs. Federal Exemptions.</u> Unless a state has affirmatively "opted out," see infra, a bankrupt debtor can choose between local state law exemptions and the federal exemptions spelled out in 11 U.S.C. § 522(d). Further:

- <u>The "State +" System.</u> As noted below, debtors choosing or forced into state exemptions also benefit from certain other exemptions in any event. Some commentators, e.g., Natalie Choate, have dubbed this the "State-Plus" system.
- <u>Variance Between State and Federal Exemptions.</u> Federal exemptions can vary considerably from local state law exemptions, this gives debtors some flexibility in both "pre-bankruptcy planning" and in maximizing the value of their exemptions.

For example, in Massachusetts, the state law homestead exemption is $500,000, while the federal homestead exemption is $15,000. Cf. M.G.L. Ch. 188 (Amd. July 28, 2004) with 11 U.S.C. § 522(d)(1). In contrast, the balance of Massachusetts' exemptions are limited and, in general, less valuable than the federal exemptions. Cf. generally M.G.L. Ch. 235, § 34 with 11 U.S.C. § 522(d). Thus, a pre-BAPA Massachusetts debtor with lots of homestead equity may opt for state law exemptions, whereas a debtor with little home equity may prefer to use federal exemptions.

Note: Because BAPA significantly improves retirement fund protection for both the federal and Stat-Plus method, debtors now can use state exemptions and still protect their retirement funds even if the state exemption is minimal.

Sec. 522 Exemption Overview (Cont'd).

"Opt Out" States. Some states, such as Ohio, have exercised their right to "opt out" from the federal scheme of exemptions. See 11 U.S.C. § 522(b)(1) (allowing states to opt out); Ohio Rev. Code § 2329.662 (Ohio's "opt out" statute). In such states, debtors are ***in general*** confined to local state law exemptions. However:

- Pre-BAPA & Post-BAPA: Federal Non-Bankruptcy Exemptions. Even before BAPA, § 522 allowed debtors choosing or forced into state law exemptions to also claim any exemptions allowed under federal nonbankruptcy law. Example:

    - 15 U.S.C. § 1671 – 1677 (limiting amount of a debtor's income that can be garnished). This exemption survives BAPA.

- Post-BAPA Federal Pension Exemptions. BAPA amended 11 U.S.C. § 522 so that very liberal pension exemptions are available as of BAPA's effective date (roughly October 17, 2005) even for debtors opting for or stuck with state law exemptions.

Note: While BAPA limits or restricts access to state law exemptions, such as the unlimited homestead, it does not do away with those rights completely.

Federal Exemptions – Relatively Unattractive. Federal exemptions are not very attractive to most debtors, even when the federal menu is available. Before BAPA, the most alluring feature of the federal menu was the pension and retirement fund exemption available under § 522(d)(10), which was in some states more protective than the exemption afforded by local law.

Now, however, BAPA has leveled the playing field by providing identical liberal protection to retirement funds under both the federal menu and the "state plus" menu. Accordingly, the incentive to use federal exemptions has diminished, particularly since the federal exemption scheme is fairly miserly apart from retirement funds.

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BAPA's New General Domicile Rules for Exemption Eligibility

- Debtors Must Domicile in State 730 Days Pre-Petition Before They Can Use State Exemptions
- Reside < 730 Days → Debtor Can Use:
  - Law of State in Which Debtor Resided Most During 180 Days Prior to 730 Days Pre-Petition
  - Federal Menu If No Place is Greatest in 180 Those Days
- Opt-Out Based on State Law Selected by Above Rules
- New Rules Aimed at "Fleeing Debtors"

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New 730 Day Domiciliary Rules for State Law Exemptions. A debtor's state of domicile is now subject to a 730 day rule. See 11 U.S.C.. § 522(b)(3)(A). Under the new rules, only persons domiciled in a state for 730 days pre-petition may use that state's local exemption laws.

> •180 Days Before 730 Days Rule. Debtors who fail the 730 day test will be deemed to be domiciled in the state where they lived during the 180 days immediately before the 730 days pre-petition. 11 U.S.C.. § 522(b)(3)(A). If a debtor lived in more than 1 state during the 180 days, then his domicile will be the place the he lived in the most during those 180 days before the 730 pre-petition days. Id.
>
> •Tie-Breaker Rule: Stuck with Federal Exemptions. If a debtor fails the 730 day test and also does not have one place that he lived in during the 180 days before the 730 days (e.g., he lived 90 days in New York and 90 days in Texas), then the debtor must use the federal exemption scheme. 11 U.S.C.. § 522(b)(3) (last sentence).
>
> •Opt-Out Rules Based On Domicile Under New Rules. Whether a debtor is stuck with an "opt out" and can only use the "state-plus" system will be based on the debtor's place of domicile as determined under the new rules. For example, if a resident of Massachusetts (which allows both state and federal exemptions) has been domiciled in the Commonwealth for only 300 days, he may not use the local Massachusetts rules because he has failed to qualify under the 730 day rule. Further, if his state of residence as determined under the 180 day rule is Ohio (an opt-out state), then the debtor is stuck with Ohio's exemptions and may not choose the federal exemptions.

Congress clearly targeted evasive debtors who moved to pro-debtor jurisdictions on the "eve of bankruptcy" when it adopted these new rules. However, given the reality of modern life, many debtors may move for legitimate job or family reasons, and not because or any intent to abscond or flee. These innocent debtors who genuinely sought to move to a new state for legitimate reasons will be deprived of the benefits conferred by their new home state.

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Congress has made it much harder for the likes of Bowie Kuhn, Marvin Warner, and others to flee to Florida, Texas, or elsewhere and then use local homestead exemptions to evade creditors. This is plainly a reaction to cases perceived as abusive.

The new rules consist of 3 basic components. In turn, each of the components has its own set of wrinkles and quirks. Nonetheless, the 3 basic general rules are as follows:

•The General 730 Day Rule. A debtor must satisfy the general 730 day domiciliary rule in order to be able to claim a local homestead exemption. See supra.

•1215 Day/$125K Cap Rule. Even if the debtor satisfies the 730 day rule, he still cannot exempt more than $125,000 in homestead equity unless he "acquired" that "amount of interest" more than 1215 days pre-petition. 11 U.S.C. § 522(p)(1).

•Ten Year Look-Back Rule for Actual Fraud Objections. Any party in interest (i.e., a bankruptcy trustee or a creditor) may object to any exemption claimed in connection with any equity acquired via a fraudulent conversion of non-exempt assets into exempt equity. 11 U.S.C. § 522(o).

Taken together, these rules may significantly reduce a debtor's ability to accumulate secure wealth in his homestead.

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§ 522(p): 1215 Days/$125K Cap (General Rule)

- Debtor's Homestead Exemption Capped at $125K if:
  - He "Acquired"
  - The "Amount of Interest"
  - Less Than 1215 Days Pre-Petition
- Acquired > 1215 Days ➔ State Law Applies

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The General 1215 Day/$125K Rule. Even if a debtor claiming exemptions under the "state plus" system satisfies the 730 day domicile rule, his right to exempt homestead equity is, in general, capped at $125,000 unless he files bankruptcy more than 1215 days after "acquir[ing]" the "amount of interest" in question. 11 U.S.C. §522(p)(1). The exact statutory phrase states, "a debtor may not exempt any amount of interest that was acquired by the debtor during the 1215-day period preceding the date of the filing of the petition that exceeds in the aggregate $125,000 in value." This general rule also has some quirks and raises some questions:

• Acquisition Date, Not Domicile Date. The 1215 day count is linked to the date on which the debtor "acquired" his "amount of interest," not to the debtor's length of residence. Thus, even long term residents of liberal homestead states can't load up on more than $125,000 in exempt homestead equity during the 1215 days pre-petition.

• What is "Acquiring" an "Amount of Interest"? BAPA doesn't explain what is meant by "acquiring" an "amount of interest," nor does it define what "an amount in interest" is (although it tells what it isn't in connection with the in-state rollover rule discussed infra), and the Committee Report is silent on these points. See generally House Rprt. 109-31. Ergo, we don't know whether acquiring an amount in interest applies:

  • Just to what the debtor pays at time of purchase.
  • Equity generated by paying down of a purchase money mortgage.
  • Appreciation value that the debtor benefits from just by good dumb luck.

• After Day 1215, is it Unlimited Exemption Redux? It ***appears*** that a debtor who acquired his homestead equity more than 1215 days pre-petition can exempt more than $125,000, up to the maximum amount allowed by state law (even an unlimited amount), assuming there are no fraudulent conversion or 730 day domicile issues.

Exceptions to General 1215 Day/$125K Rules

- Pro-Debtor Exceptions
  - No Cap for Family Farmers' Principal Residence
  - In-State Rollover Rule
- Pro-Creditor Exceptions
  - $125K Crime-Tort Cap (Even if > 1215 Days)
    - Court May Δ↑ Cap For Reasonable Necessity
  - Fraudulently Converted Equity
    - Old §§ 544 and 548 – Trustee's Avoiding Powers
    - New §522(o) – Creditor or Trustee Objections

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Congress created exceptions to the general 1215 day/$125,00 of § 522(p)(1). Some exceptions favor debtors and some of favor creditors. The pro-debtor exceptions are:

• No Cap for Family Farmers' Principal Residence. Family farmers' principal residence are exempt from the 1215 day/$125,000 rule. 11 U.S.C. § 522(p)(2)(A). However, debtors asserting this exemption must still satisfy the 730 domiciliary rule. Further, "family farmer" is a defined term subject to still-rigid eligibility rules, although BAPA did somewhat relax the eligibility rules. See 11 U.S.C. § 101(19).

• In-State Rollover Rule. Under § 522(p)(2)(B), during the 1215 days pre-petition, a debtor's "amount in interest" doesn't include any "interest" if:

- The interest is attributable to a "transfer from the debtor's previous residence" (i.e., a rollover of equity from one home to another);
- The rolled-over home was the debtor's principal residence;
- The "interest transferred" was "acquired" before the 1215 days pre-petition; and,
- The debtor's current and prior residences are in the same state

<u>Exceptions to 1215 Day/$125K Rule (Cont'd).</u>

The pro-creditor exceptions are:

- <u>Crime-Tort $125,000 Cap.</u> Under § 522(q)(1), even debtors who satisfy the 1215 day rule will still have their homestead exemption capped at $125,000 if:

    - The debtor was: i.) Convicted of a felony, and, ii.) The circumstances of the case indicate the bankruptcy filing was abusive; or,

    - The debtor owes a debt arising from: i.) Securities fraud; ii.) Fiduciary fraud; iii.) Civil RICO; or, iv.) crimes or intentional torts, or willful, or reckless misconduct that causes death or serious physical injury in the previous 5 years.

        - ***<u>Note:</u>*** The court may increase the crime-tort cap if a larger exemption is necessary for the support of the debtor or his dependents. 11 U.S.C. § 522(q)(2).

- <u>Fraudulent Transfers - Avoidance Actions.</u> A debtor's right to claim a homestead exemption is subject to the bankruptcy trustee's avoiding powers under state and federal law. See 11 U.S.C. § 522(p)(1) (cross-referencing §§ 544 and 548). This is clearly a response to cases such as *Havoco of America, Ltd. v. Hill,* 790 So. 2d 1018 (Fla. 2001). Hence, the bankruptcy trustee may use actual or constructive fraud theories to seek avoidance of fraudulent conversions into homestead equity.

- <u>Fraudulent Transfers – Objections to Exemption.</u> New § 522(o) allows the bankruptcy trustee or any creditor to object to a homestead exemption arising from an alleged fraudulent conversion. However, this device only allows challenges based on actual fraud. See infra for more details.

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Section 522(o) Objections
Fraudulent Homestead Conversions

- Creditors May Object to Fraudulent Conversions of Non-Exempt Assets into Exempt Homestead
  - 10 Year Look-Back Window
  - Creditors Can Challenge Fraudulent Conversion Without Totally Jeopardizing Discharge
    - Only Trustee Can Use §§ 548, 544 Avoiding Powers
    - Some Judges Wary of § 727 Loss of Discharge
  - Actual Fraud Only
- Fraudulently Converted Equity Isn't Exempt

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Sec. 522(o) and Objections to Homestead Exemptions. BAPA added 11 U.S.C. § 522(o), which allows a debtor's otherwise allowable homestead exemption to be reduced to the extent that the debtor's purportedly exempt homestead equity arose by way of transfers made at any time in the 10 years pre-petition with the intent to hinder, delay, or defraud. This is another "actual" fraud provision. Further:

- It is aimed at conversions of non-exempt assets into ostensibly exempt homestead equity. See § 522 (o) (referring to the debtor's disposition of property "that the debtor could not exempt")

- This rule has no impact on rollovers of exempt non-homestead assets into exempt homestead equity. However, such "exempt conversions" may still be subject to the 1215 day/$125K rule.

Sec. 522(o) (Cont'd).

Who May Object. Under Objections can be raised by any "party in interest." This means that the bankruptcy trustee or any creditor can object to an alleged fraudulent conversion into homestead equity. See Bank. R. 4003(b) (parties in interest may object to claimed exemptions); *Taylor v. Freeland & Kronz,* 503 U.S. 638, 643, 112 S.Ct. 1644, 1645 (1992) ("Rule 4003(b) gives the trustee and creditors 30 days from the initial creditors' meeting to object"). See also *In re James Wilson Associates,* 965 F.2d 160, 169 (7th Cir. 1992) ("'Party in interest' means 'anyone who has a legally protected interest that could be affected by a bankruptcy proceeding").

- Departure From Prior Standing Rules. New § 522(o) gives creditors the right to unilaterally challenge and avoid an intentional fraudulent conversion into homestead equity. This changes well established standing rules. Previously, under §§ 544 and 548, only bankruptcy trustees could mount such challenges. However, many harried and burdened trustees will simply refuse to challenge fraudulent transfers of any sort unless it is flagrant and involves huge sums. This meant many valid fraudulent transfer claims went unchallenged, thus leaving creditors frustrated.

Sec. 522 Objection Is In Addition to Other Tools. Sec. 522(o)'s new objection mechanism is in addition to other tools that have long been available to challenge a fraudulent conversion, i.e. 11 U.S.C. §§ 544 and 548 (trustee's avoiding powers under state law and Bankruptcy Code) and § 727 (adversary proceeding by creditor or trustee challenging debtor's right to discharge on grounds of fraudulent transfer or fraudulent concealment).

- Sec. 727 Unappealing to Many Creditors. Even though creditors are entitled to sue under § 727, many choose not to, even if the debtor's fraudulent transfer appears flagrant. In addition to considerations of expense, § 727 adversary proceedings are unattractive for the following reasons:

    - Many judges are especially leery of § 727 claims because, if successful, they result in a complete loss of discharge. Simply put, some judges think this is unduly harsh.
    - Because a successful claim totally precludes a discharge, it benefits all creditors, not just the one filing the adversary proceeding. This creates a "free rider" problem, i.e., plaintiff-creditor picks up all the expense, but all creditors share in the potential benefits.

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BAPA's Basic Retirement $$ Exemptions

- General Rule – Most Tax Deferred Pensions Exempt
  - IRC §§ 401, 403, 408, 408A, 414, 457, or 501(a)
- Exception to General Rule – $1,000,000 IRA Cap
  - § 522(n) ➔ IRAs and Roths Exempt Only Up to $1,000,000
- Exceptions to IRA Exception (i.e. No Cap Applies):
  - SEPs
  - SIMPLEs
  - Rollovers
  - Earnings on Rollovers
  - Court Increases Limit in "Interests of Justice"
- Beware: UFTA Issues
  - Fraud Hard to Prove in Bona Fide Pension Planning Context

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General Rule – Tax Deferred Pensions Exempt. Under BAPA, 11 U.S.C. § 522 establishes a general rule that most tax deferred pensions are exempt. Under both §§ 522(d)(12 (pure federal exemption scheme) and 522(b)(3)(C) (state exemptions plus certain specified federal exemptions), the following pensions are protected:

•Pension funds exempt under IRC §§ 401, 403, 408, 408A, 414, 457, or 501(a).

Exception to Rule General Rule - $1,000,000 IRA Exemption Cap. BAPA added new 11 U.S.C. § 522(n), which created a general rule that capped individual debtor's IRA and Roth exemptions at $1,000,000.

Exception to Exception – Ways to Exceed the $1,000,000 Cap. However, the $1,000,000 cap on IRA funds is subject to significant exceptions. In particular, the following IRA assets are not subject to the cap:

•SEPs - Simplified employee pension under IRC § 408(k).

•SIMPLEs - Simple retirement account under IRC § 408(p).

•Rollovers - Rollover contributions under IRC §§ 402(c), 402(e)(6), 403(a)(4), 403(a)(5), and 403(b)(8) and earnings thereon,.

Further, the court may increase the $1,000,000 IRA cap "if the interests of justice so require."

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BAPA's Code § 522 Has Other Pension Wrinkles. BAPA also creates other wrinkles that help protect retirement assets in bankruptcy, such as:

•**IRS Determination Letter Rule.** "If the retirement funds are in a retirement fund that has received a favorable determination under section 7805 of the Internal Revenue Code of 1986, and that determination is in effect as of the date of the filing of the petition in a case under this title, those funds shall be presumed to be exempt from the [debtor's bankruptcy] estate." 11 U.S.C. § 522(b)(4)(A).

In the past, bankruptcy courts would sometimes look behind a favorable determination letter and independently assess whether a plan was qualified and compliant with IRS rules. See, e.g., the following: *In re Youngblood,* 29 F.3d 225 (5th Cir. 1994) (court's conclusion based more on IRS plan audit than on IRS plan determination letter); *In re Lawrence,* 235 B.R. 498 (S.D. Fla. 1999) (court independently evaluated plan's compliance); *In re Blais,* 220 B.R. 485 (S.D. Fla. 1997). See also *Richie v. The American Council on Gift Annuities,* 943 F.Supp. 685 (N.D. Tex. 1996) (regarding IRC § 501(c)(3) letters).

•**Innocent Foul-Up Rule (No Letter Rule).** Under 11 U.S.C. § 522(b)(4)(B), if there is no favorable determination letter pursuant to IRC § 7805, the pension funds are still exempt if the debtor proves:

•No prior contrary determination has been made; and,

•Either of the following apply: The plan is in substantial compliance with the Internal Revenue Code, or, alternatively, "the debtor is not materially responsible for" the plan's noncompliance with the IRC.

•**Pension Plan Changeover Rules.** Under 11 U.S.C. § 522(b)(4)(C) and (D), pension funds stay exempt even if they're moved from one exempt fund to another (a "trustee to trustee" transfer) or if the funds are rolled over within the meaning of IRC § 402(c).

•However, rollover funds will lose their exemption if they aren't re-deposited within 60 days to another exempt plan (i.e., a plan governed by IRC §§ 401, 403, 408, 408A, 414, 457, or 501(a)).

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<u>Key Pre-BAPA's Pension Protections Also Continue.</u> The following pre-BAPA pension protections continue post-BAPA (although they may be irrelevant):

• <u>ERISA & "Property of the Estate."</u> ERISA funds are still not property of the debtor's bankruptcy estate. See 11 U.S.C. § 541(c)(1) (regarding applicable nonbankruptcy law, i.e., spendthrift clauses); *Guidry v. Sheet Metal Workers Pension Fund*, 493 U.S. 365, 110 S.Ct. 680 (1990) (re same); *Patterson v. Shumate*, 504 U.S. 753, 112 S.Ct. 2242 (1992) (re same).

• Big Point: No more worries over "one man shops." This rule, which exposed the ERISA interests of individuals or married persons who owned 100% of a business, was based on a Department of Labor regulation and related case law. See, e.g., the following:

• *Yates v. Hendon,* 541 U.S. 1, 124 S. Ct. 1330 (2004) (ERISA interest of single owner of business protected so long as business has at least one employee other than the owner).

• Sullivan, *Gutting the Rule Against Self-Settled Trusts: How the New Delaware Trust Law Competes With Offshore Trusts,* 23 Delaware J. Corp. Law 423, 429, n. 27 (1998) (analyzing old "one man corporation" rule).

• <u>*Rousey* Rule.</u> If the debtor is using the "pure" federal exemption scheme, then *Rousey v. Jacoway,* 544 U.S.___ (April 4, 2005), and 11 U.S.C. § 522(d)(10) still apply to exempt those IRA funds that aren't already exempt and for which the debtor can prove reasonable necessity.

• However, it's hard to imagine a case of reasonable necessity under § 522(d)(10) that won't also justify raising the $1,000,000 cap "in the interests of justice" under § 522(n).

<u>UFTA Still Applies.</u> Fraudulent transfers of assets to a pension plan can still be avoided. Cf. *In re Goldschein,* 241 B.R. 370, 379 (Bankr. D. Md. 1999) ("The anti-alienation provision of ERISA and the Internal Revenue Code do not preclude the avoidance of fraudulent transfers").

• However, pension planning made with normal retirement planning in mind is probably not tainted by fraudulent intent.

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SEP-IRAs & *Lampkins*

- *Lampkins* Undermines State SEP Exemptions
  - SEPs Are Employer Sponsored Plans
    - Hence, SEPs are Subject to ERISA
  - ERISA Doesn't Protect SEP-IRAs
    - ERISA Doesn't Protect IRC § 408 Plans (e.g., SEPs)
  - ERISA Preempts State Law
  - This Makes SEPs Attachable
    - Federal Law Doesn't Protect SEPs
    - State law Exemptions Preempted
    - SEPs Left Unprotected

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Lampkins v. Golden, 2002 U.S. App. LEXIS 900; 2002-1 U.S. Tax Cas. (CCH) P50,216; 27 E.B.C. 1587 (Issued 17 January 2002). Not recommended for full-text publication. See 6th Cir. Rule 28(g).

Plaintiff Lampkins successfully sued her ex-employer, attorney Golden, and his firm's ERISA plan for alleged ERISA violations. Lampkins was awarded approximately $12,000 for ERISA violations and another $5,213.58 in costs and attorneys fees (apparently a sanction for Golden's failure to comply with discovery requests). When Lampkins tried to collect, Golden claimed he had no assets or income. Post-judgment discovery revealed, however, that Golden had established a SEP-IRA worth about $90,000. Lampkins tried to garnish the SEP-IRA. Golden claimed the SEP-IRA was exempt on one or both of the following theories: i.) Federal ERISA anti-alienation spendthrift protection, 29 U.S.C. §1056(d)(1); or, ii.) Michigan state law SEP-IRA exemptions, Mich. Comp. Laws Anno. § 600.6023(k). Held:

> ERISA Does Not Protect SEP-IRAs. Under 29 U.S.C. § 1051(6), ERISA's anti-alienation protection does not extend to any IRA formed pursuant to IRC § 408. Since SEP-IRAs are IRAs formed pursuant to IRC § 408, ERISA's anti-alienation rules don't apply to SEP-IRAs.
>
> ERISA Preempts State Law. Under 29 U.S.C. 1144(a), ERISA preempts all state law "relate[d] to any employee benefit plan," including state laws dealing with SEP-IRAs.
>
> SEP-IRAs Are Garnishable. Federal law does not protect SEP-IRAs because ERISA's anti-alienation protection does not cover IRAs. State law exemptions cannot protect SEP-IRAs because ERISA preempts state law. Since no state or federal law protects SEP-IRA's, they are "garnishable"/attachable.

Consequently, Pre-BAPA, SEP-IRAs were unprotected in Sixth Circuit, at least in state court and U.S. District Court cases. Only Congress, 6th Circuit or U.S. Supreme Court can fix this. Accord, *In re Diguilio,* 2003 Bankr. LEXIS 1739 (Bankr. N.D. Ohio 2003).

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Lampkins Has Limits

- *Lampkins* Doesn't Apply to Traditional IRAs
  - IRAs Not Employer Sponsored ➔ Not Under ERISA
- *Lampkins* is "Unpublished"
  - Limits Precedential Value (Maybe, Perhaps, I Dunno)
- *Lampkins* Doesn't Apply in Bankruptcy
  - Pre-BAPA ➔ ERISA Savings Clause Analysis
  - Post-BAPA ➔ New § 522 Rules

Still… A Big Mess!

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Limits to Lampkins. Before BAPA, the raging controversy over *Lampkins* in the Sixth Circuit has produced at least one clear limit to *Lampkins* and two arguable limits to *Lampkins.* These three arguments are as follows:

• Traditional IRAs Not Covered. *Lampkins* does not apply to traditional IRAs. ERISA preempts state law exemptions for SEPs only because SEP-IRAs are employer sponsored plans. Traditional IRAs, however, are maintained by individuals, not employers, so ERISA does not cover traditional IRAs and preemption is not an issue for these vehicles.

• The "Unpublished" Opinion. *Lampkins* is unpublished and, arguably, lacks precedential value. See 6th Cir. Rule 28(g). However, it's hard to ignore a Federal Circuit Court opinion that everybody knows about, especially when it's supported by cogent (if unpleasant) logic.

• Pre-BAPA ➔ Lampkins May Not Apply in Bankruptcy (ERISA Savings Clause). Although the bankruptcy courts in the Sixth Circuit are divided on this point, at least some feel that ERISA's "savings" clause protects SEPs in bankruptcy. This argument posits that the savings clause "saves" other federal laws – and state laws designed to advance a federal scheme – from ERISA preemption; that federal exemptions under 11 U.S.C. § 522 are therefore saved; and, likewise, the savings clause saves state exemption laws that are incorporated into the Bankruptcy Code because they advance the "fresh start" policy of the Code.

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Lampkins & ERISA's Savings Clause (Cont'd). Pre-BAPA, the savings clause argument was perhaps valid in connection with the federal law exemptions under § 522. See, e.g., *In re Good,* Ch. 7, Case No. 03-22228 (Bankr. N.D. Ohio 2004).* However, this approach risks inconsistent interpretations of state exemption laws, depending upon whether the exemption is asserted in state court or federal district court, where the Bankruptcy Code is not at issue, or in bankruptcy court.

In Pre-BAPA cases, this risk is especially acute in "opt out" states, in which the only exemption scheme is state law. In such states, the legislatures arguably opted out of the federal exemptions in order to create consistency in exemption law regardless of which court presides over a case. The "savings clause" argument defeats that legislative objective by creating inconsistent results.

Case Law. Many of these issues have been discussed or alluded to in numerous post-*Lampkins* and pre-*Lampkins* cases dealing with SEPs and traditional IRAs. See, e.g., the following:

In re Brucher, 243 F.3d 242 (6th Cir. 2001)

In re Buzza, 287 B.R. 417 (Bankr. S.D. Ohio 2002)

In re Diguilio, 2003 Bankr. LEXIS 1739 (Bankr. N.D. Ohio 2003)

In re Good, Ch. 7, Case No. 03-22228 (Bankr. N.D. Ohio 2004)*

In re Mitchell, 2002 Bankr. LEXIS 1217 (Bankr. N.D. Ohio 2002)

In Re Rayl, 299 B.R. 465 (Bankr. S.D. Ohio 2003)

In re Schreiner, 255 B.R. 545 (Bankr. S.D. Ohio 2000)

* *In re Good* is unpublished in any data base or case reporter but is available via the federal courts' PACER/ECF system.

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<u>Effect of BAPA on *Lampkins* and SEPs.</u> Post-BAPA, new § 522 protects SEPs, SIMPLEs, and practically all tax-deferred pension plans, whether debtor uses state exemption or federal exemption menu. See 11 U.S.C. §§ 522(b)(3)(C) (state exemptions plus federal pension exemptions), 522(d)(12) (federal exemptions). However, there are other post-BAPA wrinkles:

• *Lampkins* is still potentially good law outside bankruptcy court, i.e., in state court, federal district court, etc. This would create different exemption standards in different courts. As a result:

• Planners may have to assess the potential for different levels of protection depending upon whether the client is in or out of bankruptcy

• Solvency calculations may differ significantly, depending upon whether the client is willing to leave SEPs exposed out of bankruptcy (hence making them includible in asset tallies for solvency calculation purposes) or whether the client wants to protect SEPs in bankruptcy (thus making them exempt and non-includible in asset tallies for solvency calculations). See UFTA § 1(2)(ii) (term "asset" "does not include... property to the extent it is generally exempt under nonbankruptcy law").

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Exemptions & Fraudulent Conversions

- Exempt Property Is By Law Off Limits to Creditors
  - It Can't Be Attached or Seized
  - Purpose Is to Prevent Debtors and Dependents From Going on the Dole and to Maintain a Decent Lifestyle
  - What's Exempt Varies State by State, Circuit by Circuit
  - Examples: IRAs, Homesteads, Insurance, Annuities
- The Obvious Temptation:
  - Convert Non-Exempt Assets to Exempt Form to Evade Creditors
- This May Be Deemed a "Fraudulent Conversion"
  - Basically an UFTA Violation
  - Transfer Made With Intent to Hinder, Delay, or Defraud
- Converting Non-Exempt Assets into Exempt Form Can Result in Loss of Discharge
  - Especially "Eve of Bankruptcy" Filings

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Note Well:

Detailed citations to authority regarding fraudulent conversions are contained in the traditional text outline material accompanying this slide show. Additional comments and citations are made on the following few pages.

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But… Isn't Exempt Property Meant to Stiff Creditors?

- Of Course It Is! Hence, Great Judicial Tension:
  - Enforce UFTA vs. Allow Legal Exemptions
- Some "Pre-Bankruptcy Planning" is OK
  - Exact Boundary Lines are Unclear
  - Debtors Can Often Convert Some Assets to Exempt Form
  - But Not All Conversions are OK
- No Real Principled Basis to Distinguish Many Cases
  - Courts Admit They're All Over the Map on This Issue
  - See, e.g., *In re Holt,* F.2d 1005, 1008 - 1009 (8th Cir. 1990)

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There is obvious tension between the theories of "fraudulent conversion" and exempt property. The whole purpose of exempt property is to put property beyond the reach of creditors. See *In re Kravitz,* 225 B.R. 515, 518 (Bankr. D. Mass 1998). ("But exemptions by their very nature frustrate creditors"). Moreover, the right to use exempt property is conferred by state and/or federal statute and, as to certain state homestead laws, by state constitutions. Further, the House Report to 11 U.S.C. § 522, which lists the federal exemptions available in many bankruptcy proceedings, expressly states, "As under current law, the debtor will be permitted to convert nonexempt property into exempt property before filing a bankruptcy petition. See Hearings, pt. 3, at 1355-58. ***The practice is not fraudulent as to creditors, and permits the debtor to make full use of the exemptions to which he is entitled under the law.***" H. R. Rep. No. 95-595, at 361 (1977) (emphasis added). See also Sen. Rep. No. 95-989, at 76 (1978).

As one court noted,

Ergo, how can it be wrongful for debtors to avail themselves of legal rights?

On the other hand, courts are understandably worried about the adverse consequences that might befall innocent creditors when a debtor, with fulsome intent to "keep it all" for himself, places every available dime into an exempt asset. Such transactions inevitably involve a transfer (e.g., taking non-exempt cash and tendering it to an insurance company in exchange for an annuity) that is arguably designed to "hinder" or "delay" creditors. (One might argue that the intent is not to "hinder" or "delay," terms which imply that the creditor has some eventual right reach the assets in question, but is instead to lawfully, permanently, and forever cut off the rights of the creditor to the assets in question. But that just begs the question of what is lawful.) If so, then the transfer might be deemed fraudulent.

Other times, courts rule that the converted sums, while substantial, simply aren't "too much" to warrant the harsh penalty of denying a discharge. But how much is "too much?" This is where matters get murky.

The Old Wall Street Adage Is the Best Test for Fraudulent Conversions

- Cases Often Seem to Turn on How Much The Debtor is Trying to Convert at the Last Minute

Bears Get Fat...

Bulls Get Fat...

Hogs Get Slaughtered...

So Don't Be a Pig!!!

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"Unfortunately, the line between legitimate pre-bankruptcy planning and intent to defraud creditors contrary to section 727(a)(2) is not clear." *Swift v. Bank of San Antonio (In re Swift),* 3 F.3d 929, 931 (5th Cir. 1993). As noted in a letter to Congress by a California bankruptcy judge regarding the old Bankruptcy Act, "[C]onversion of non-exempt assets into exempt assets on the eve of bankruptcy is not, standing alone, fraudulent" in the Ninth Circuit, and "the law on this point is in a state of utter confusion in other circuits. . . ." See *In re Kravitz,* 225 B.R. 515, 518 (Bankr. D. Mass 1998). The same California judge opined to Congress, "[M]ost of what is done in the name of 'prebankruptcy planning' borders on outright fraud, as far as I am concerned." *Id.*

While the above slide may seem to be an attempt to "ham it up," and while it perhaps does not reflect the most enlightened jurisprudence, it is, alas, consistent with the state of the art in this field. See, *Swift,* 3 F.3d at 931, quoting *Albuquerque Nat'l Bank v. Zouhar* (*In re Zouhar*), 10 B.R. 154, 157 (Bankr. D.N.M. 1981), in turn quoting *Dolese v. U.S.*, 605 F.2d 1146, 1154 (10th Cir. 1979) for the proposition that "there is a principle of too much; phrased colloquially, when a pig becomes a hog it gets slaughtered."

The above "hogs and pigs" case law are cited and quoted in Coco & Christian, *Squirreling It Away; The Business Lawyer's Role In Pre-Bankruptcy Planning,* Business Law Today, Vol. 12, No. 3 (Jan./Feb. 2003), available on-line at:

www.abanet.org/buslaw/blt/2003-01-02/coco.html

However, these cases are not the only animals lurking about. In the early 1990s, the author of this outline attended a bankruptcy CLE in which one of the featured speakers had served as a member of the U.S. Trustee's office in Tennessee. He reported that he searched for "pigs and hogs" cases in electronic data bases and found dozens of cases relying on this high cholesterol legal maxim.