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BANKRUPTCY

Exemptions for Personal Injury Structured Settlements

The principal reason that an individual files a petition under Chapter 7 of the Bankruptcy Code[1] is to obtain a discharge of dischargeable debts. As a quid pro quo, however, the individual must deliver non-exempt assets to the trustee in bankruptcy for the benefit of creditors. Thus, of significant concern to a potential debtor in bankruptcy are the assets he or she may retain through the Chapter 7 proceeding.

Exemption statutes are generally designed to facilitate the debtor's "fresh start," enabling the debtor to start anew, armed with a modest amount of assets sufficient to enable him to capitalize on this new opportunity in life.[2] In the 22 years since the enactment of Debtor and Creditor Law Article 10-A, the New York bankruptcy bar has routinely counseled prospective debtors in bankruptcy that, pursuant to Debtor and Creditor Law §282(3)(iii), if an individual is a plaintiff in a personal injury action pending at the time of bankruptcy, he or she may exempt from creditors "[a] payment, not to exceed $7,500 on account of personal bodily injury, not including pain and suffering or compensation for actual pecuniary loss, of the debtor or an individual of whom the debtor is a dependent."

There exists authority in the Eastern District of New York that to the extent a personal injury recovery includes a payment directly traceable to the loss of future earnings,

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such portion of the personal injury settlement may be exempted as well under Debtor and Creditor Law §282(3)(iv) which exempts "a payment in compensation of loss of future earnings of the debtor or an individual of whom the debtor is or was a dependent, to the extent reasonably necessary for the support of the debtor and any dependent of the debtor." *In re Corby*, 149 B.R. 325 (Bankr. E.D.N.Y. 1993) (Duberstein, Chief Judge). However, for a portion of a personal injury recovery to be exempt under this subsection there must be a specific allocation of the recovery to loss of future income and secondly a determination that the recovery is reasonably needed for the support of the debtor and his or her dependents. *In re Corby*, 149 B.R. at 331.

Seen from this context, in the typical Chapter 7 bankruptcy case involving a serious personal injury action, it is common that the creditors of the bankruptcy estate receive the bulk of the personal injury award, with a comparatively modest amount available to aid the debtor in his or her fresh start.

In this context, the 2002 case of *In re Stahlman*,[3] in which this author was the Chapter 7 trustee, constitutes a meaningful departure from this exemption scheme. In *Stahlman*, over four years before she filed for bankruptcy, Sue Ann Stahlman settled a pre-petition personal injury action under a structured settlement agreement which called for the payment of $112,500 at such time, and the balance of $283,561 over a period of 25 years. The funding of the future payments was to be met by her defendant's insurer through its purchase of an annuity from a reputable life insurance company. Prior to the filing of her bankruptcy petition, Ms. Stahlman had received the first installment of $20,000, leaving a balance of $263,561 to be paid over time.

The trustee argued, inter alia, that Ms. Stahlman was limited to the amount of $7,500 under New York Debtor and Creditor Law §282(3). In response, Ms. Stahlman took the position that insofar as the structured settlement was funded by an annuity, of which she was beneficiary, the annuity was completely exempt under §282 of the New York Debtor and Creditor Law and §3212 of the New York State Insurance Law.

New York State Debtor and Creditor Law §282 incorporates into bankruptcy law the annuity exemption otherwise available under New York law. It states in relevant part:

> Under Section 522 of Title 11 of the United States Code, entitled "Bankruptcy" an individual debtor domiciled in this state may exempt from the property of the estate, to the extent permitted by subsection (b) thereof, only ... (ii) insurance policies and annuity contracts and the proceeds and avails thereof as provided in section 3212 of the Insurance Law ....

Insurance Law §3212(d)(1) provides

in pertinent part:

> The benefits, rights, privileges and options which, under any annuity contract are due or prospectively due the annuitant, who paid the consideration for the annuity contract, shall not be subject to execution.

In an unwritten decision, rendered from the bench on March 14, 2002, U.S. Bankruptcy Judge Dorothy Eisenberg followed the then recent en banc decision of the U.S. Court of Appeals for the Fifth Circuit reversing the prior decision of *In re Orso*, 214 F.3d 637 (5th Cir. 2000). *In re Orso*, 283 F.3d 686 (5th Cir. 2002) (en banc).

Judge Eisenberg determined that notwithstanding the fact that the annuity emanated from a structured settlement of a personal injury award, it nevertheless qualified as an annuity within the meaning of 3212 of the New York Insurance Law, and was therefore exempt under that section. The judge found that the requirement that the exemption could only be taken by the person "who paid the consideration for the annuity contract" was met under the facts of the case. Judge Eisenberg reasoned that the fact that the debtor had relinquished her rights against the defendant and agreed to accept her payment over time instead of in a lump sum, constituted the requisite consideration under the statute.

In reaching this conclusion, Judge Eisenberg relied on the definition of "consideration" contained in Black's Law Dictionary which included something that induces a party to enter into a contract, including forbearance. Finally, when met with the issue that the court's expansive interpretation of the annuity statute opened the door to sophisticated bankruptcy planning that could be utilized by a debtor to promote a "head start,"[4] as opposed to a "fresh start," the court concluded that in the event a trustee could establish that such a structured settlement was funded by the purchase of an annuity with the intent to hinder, delay or defraud creditors, such intent might taint the exempt status of such annuity.

Implications

The *Stahlman* decision is important for general practitioners and personal injury attorneys alike. If a personal injury plaintiff intends to rely on a personal injury settlement not for short term needs but to create an income stream over time, i.e. for the purposes for which an annuity is purchased, *Stahlman* would provide a basis to protect said income stream from creditors. Alternatively, in the event that a personal injury plaintiff is without substantial assets, or may thereafter incur debt beyond his or her ability to repay, or otherwise may be a future candidate for a bankruptcy filing, some thought should also be given to structuring the settlement in the form of an annuity, mindful of the admonition that the annuity should not be created to hinder, delay or defraud creditors.

Moreover, there are other implications to the *Stahlman* decision, and the *Orso* decision upon which it is based. In *Orso*, the Fifth Circuit expressly overruled the case of *Young v. Adler (In re Young)*, 806 F.2d 1303 (5th Cir. 1987). In *Young v. Adler*, an attorney had filed a voluntary petition for relief under Chapter 7 of the Bankruptcy Code. There, the debtor in the course of his representation of certain plaintiffs in a wrongful death action, was paid, for his services under a structured settlement, the sum of $25,000 immediately, and he was scheduled to receive monthly payments of $1,875 for 14 years.

The Fifth Circuit reasoned that while the debtor's right to payment arose under an annuity created for his benefit, the court nevertheless had the obligation to look behind the annuity to the substance of the underlying arrangement. The court determined that the payments to which the debtor was entitled were nothing more than payments for services rendered, and therefore essentially accounts receivable. Because an account receivable was not an exempt asset under applicable law, the debtor could not retain the payments due under the annuity in derogation of the rights of his creditors.

The express reversal of *Young v. Adler* by the *Orso* court would therefore render the legal fees payable to Mr. Young, funded through the purchase of an annuity, exempt under the reasoning of *Orso*. In the event that the *Stahlman* court is prepared to follow *Orso* in its entirety, then it is reasonable to conclude that under its rationale a payment relationship similar to that described in *Young v. Adler* will be deemed exempt under New York law as well.

The *Orso*, and therefore *Stahlman* analysis, might be utilized to justify the exemption of other income streams. For example, if a debtor were owed a garden variety account receivable, but chose instead to utilize the proceeds to purchase an "annuity contract," would these payments over time, emanating from a non-exempt asset nevertheless be exempt?[5]

While in common parlance, an "annuity contract" is ordinarily viewed as an insurance product, the statutory definition does not contain such an express limitation. Under New York Insurance Law §3212 an annuity contract includes "any obligation to pay certain sums at stated times, during life or lives, or for a specified term or terms, issued for a valuable consideration ...." Facially, then, any contractual entitlement to receive payments over time might arguably fall within the statutory definition. Thus, it may be incumbent upon the practitioner to claim any income stream to which the debtor is entitled, as an exempt annuity, until *Stahlman*, and *Orso* are clarified by subsequent decisions.[6]

1. 11 U.S.C. §101 et seq.

2. See generally *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934) (quoting from *Williams v. U.S. Fidelity and Guar. Co.*, 236 U.S. 549, 554-555 (1915); Benjamin Weintraub and Alan N. Resnick, Bankruptcy Law Manual §1.02[1][a]N.2., 1.3 (Warren Gorham and Lamont, Inc. 1980).

3. *In re Richard K. Stahlman and Sue Ann Stahlman*, Case No.: 01-82000-478 (Bankr. E.D.N.Y. 2001) (Eisenberg, J.).

4. *Lines v. Frederick*, 400 U.S. 18, 91 S.Ct. 113, 27 L.Ed.2d 124 (1970); *State Bank of India v. Chalasani (In re Chalasani)*, 92 F.3d 1300 (2d Cir. 1996); *In re Kokoszka*, 479 F.2d 990 (2d Cir. 1973).

5. Under New York Debtor and Creditor Law §283 the unlimited annuity exemption is only available with respect to annuities purchased more than six months prior to the filing of the bankruptcy petition. Annuities created within six months of filing are subject to a ceiling which limits a debtor's exemption to a total of $5,000 in value of assets described collectively under §5205 of the New York C.P.L.R. and annuities covered by §3212 of the Insurance law.

6. In both *In re Brown*, 86 B.R. 944 (N.D.Ind. 1988) and *In re Miller*, 16 B.R. 790 (Bankr. D.Md. 1982), bankruptcy courts denied to debtors their claim of exemption in lottery winnings, payable to the debtors in the form of annuities. Under *Stahlman* and *Orso*, the result may be different.

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