THE 100% BANKRUPTCY EXEMPTION FOR PERSONAL INJURY STRUCTURED SETTLEMENTS: FRESH START OR HEAD START

By: Robert L. Pryor

The principal reason that an individual files a petition under Chapter 7 of the Bankruptcy Code[1] (the "Code") 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 s/he 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 the debtor to capitalize on this new opportunity in life.[2] While the facilitation of a "fresh start" is central to the bankruptcy rehabilitation process, it is equally ingrained in the case law that such a fresh start should not be confused with a "head start" which is universally decried by the courts.[3]

Section 522 of the Code governs a debtor's right to exemptions. Section 522(b) authorizes each state to create its own body of exemptions, and in so doing, to "opt out" of the Federal exemption scheme set forth in Section 522(d). In response to this grant of authority, on May 17, 1982, New York opted out of the Federal exemption scheme by enacting Article 10-A of the New York Debtor and Creditor Law (Sections 282-284). As a consequence, Debtors domiciled in the State of New York may claim exemptions only under the New York exemption statute.

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 Section 282(3)(iii), if s/he is a plaintiff in a personal injury action pending at the time of bankruptcy, s/he may exempt from creditors "[a] payment, not to exceed $7,500.00 on account of

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[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 & Alan N. Resnick, Bankruptcy Law Manual Section 1.02[1][a]N.2., 1.3 (Warren Gorham and Lamont, Inc. 1980).

[3] 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); In re Geise, 992 F.2d 651 (7th Cir. 1992); In re Zick, 931 F.2d 1124 (6th Cir. 1991); In re Krohn, 886 F.2d 123 (6th Cir. 1989); First Tex. Sav. Ass'n. v. Reid (In re Reid) 700 F.2d 986 (5th Cir. 1983); Taylor v. Taylor, 199 B.R. 37 (N.D.Ill. 1996); In re Scheinberg, 134 B.R. 426 (D.Kan. 1992); In re Chabot, 131 B.R. 720 (C.D.Cal. 1991); Richardson v. United States, 386 F.Supp. 424 (C.D.Cal. 1974).

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." N.Y.Deb & Cred Law §282(3)(iii).

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, such portion of the personal injury settlement may be exempted as well under Debtor and Creditor Law Section 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, the exemption available under New York law for the proceeds of a personal injury action is a limited exemption, available to shelter the modest sum of $7,500.00 together with amounts specifically attributable to loss of future income, and then only to the extent reasonably necessary for the support of dependents. Accordingly, as a result, 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 case of In re Stahlman,[4] constitutes a meaningful departure from this exemption scheme, effectively expanding the New York State personal injury exemption to levels which facially appear to go well beyond amounts needed by a debtor to facilitate his or her fresh start.

In Stahlman, over four years before she filed for bankruptcy, Mrs. Stahlman settled a pre-petition personal injury action under a structured settlement agreement which called for the payment of $112,500.00 at such time, and the balance of $283,561.00 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, Mrs. Stahlman had received the first installment of $20,000.00, leaving a balance of $263,561.00 to be paid over time. The Trustee objected to Mrs. Stahlman's claim of exemption, arguing, inter alia, that Mrs. Stahlman was limited to the amount of $7,500.00 under New York Debtor and Creditor Law Section 282(3). In response, Mrs. Stahlman took the position that insofar as the structured settlement was funded by an

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

annuity, of which she was beneficiary, the annuity was completely exempt under Section 282 of the New York Debtor and Creditor Law and Section 3212 of the New York State Insurance Law.

New York State Debtor and Creditor Law Section 282 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 Section 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 response to the Debtor's contention that the structured settlement was fully exempt as an annuity, the Trustee made several arguments. First, the Trustee contended that the purpose of Section 3212 of the Insurance Law was to create an exemption for income streams that are in the nature of retirement and disability pension plans, and that the incorporation by reference of the Insurance Law in the New York bankruptcy exemption statute imported the legislative intent underlying Section 3212.[5]

Next, the Trustee argued that if one looked beyond the form to the substance of the asset, the payment stream to which the Debtor was entitled, although funded through the purchase of an annuity, was nothing more than a debt or an account receivable, neither of which would be exempt under New York law.

Finally, the Trustee argued that even assuming arguendo that the Debtor's entitlement to the future payments was properly characterized as an annuity, it nevertheless failed to meet the requirements under Insurance Law Section 3212(d)(1), because under that statute, the exemption is available only to the person "who paid the consideration for the annuity contract."

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[5] In taking this position, the Trustee relied upon a series of cases interpreting various states statutes which created a bankruptcy exemption for annuities, including In re Orso, 214 F.3d 637 (5th Cir. 2000); Young v. Adler (In re Young), 806 F.2d 1303 (5th Cir. 1987); In re Lindsay, 261 B.R. 209 (Bankr. S.D. Ohio 2001); In re Rhinebolt, 131 B.R. 973 (Bankr. S.D. Ohio 1991); In re Johnson, 108 B.R. 240 (Bankr. D.N.D. 1989); and In re Simon, 71 B.R. 65 (Bankr. N.D. Ohio 1987); but see In re Ziegler, 156 B.R. 151 (Bankr. W.D.Pa. 1993) and In re Daniel F. Terrance, No. 00-13083 (Bankr. N.D.N.Y. December 14, 2001) (Littlefield, J.).

In an unwritten decision, rendered from the bench on March 14, 2002, Bankruptcy Judge Dorothy Eisenberg followed the then recent en banc decision of the Fifth Circuit Court of Appeals 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) (Orso).

In her decision, 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", 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.

Initially, 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 $25,000.00 immediately, and thereafter, monthly payments of $1,875.00 for fourteen years. The Fifth Circuit reasoned that while the debtor's right to payment arose under an annuity created for his benefit, it 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?[6]

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 Section 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.

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. In each case, the court looked behind the label and the manner of funding the payment in concluding that such an annuity was not intended to be exempt under the applicable exemption statute. It is submitted that there is little to distinguish cases of this type from Orso and Stahlman. If the rationale of Stahlman and Orso is that it is inappropriate to look beyond the label to determine the exemptability of an asset, then lottery winnings which take the form of an annuity should be similarly exempt. Thus, a practitioner is well counseled to consider the impact of Stahlman and Orso on these as well as analogous situations in interpreting the New York exemption statute to maximize the assets which may be exempted by a debtor from his/her creditors.

[6] Under New York Debtor and Creditor Law Section 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 $5,000.00 in value of assets described collectively under Section 5205 of the New York C.P.L.R. and annuities covered by Section 3212 of the Insurance law.

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