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BANKRUPTCY LAW

You Can't Always 'Trust' an Annuity

Annuities that did not qualify as trusts were included in bankruptcy estate

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The United States District Court for the District of New Jersey recently affirmed a bankruptcy court decision finding that two annuities owned by a Chapter 7 debtor were not excluded from the bankruptcy estate under Bankruptcy Code § 541(c)(2). *Hill v. Dobin*, (D.N.J. Dec. 5, 2006). The District Court concluded that although the annuities were subject to a restriction on transfer, they were not trusts, resulting in a fatal flaw to the debtor's argument.

The debtor purchased two annuities prior to filing for bankruptcy protection. The plans were neither ERISA-qualified plans nor pension plans, but purchased as retirement accounts. The debtor listed the plans on Schedule B of her bankruptcy schedules subject to a disclosure stating "not property of Debtor Estate — for notice purposes only." The Chapter 7 Trustee filed an adversary proceeding seeking declaratory relief in the form of an order declaring that the two annuities were property of the bankruptcy estate. After limited discovery was conducted, the Chapter 7 Trustee moved for summary judgment.

The issue before the bankruptcy court was whether the two annuities qualified for exclusion from the bankruptcy estate under Bankruptcy Code § 541(c)(2). Under this section of the Bankruptcy Code, "a restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable nonbankruptcy law is enforceable in a case under this title." 11 U.S.C. § 541(c)(2). To qualify for exclusion, the debtor must show "(1) the asset represents the debtor's beneficial interest in a trust, (2) there is a restriction on transfer, and (3) the restriction is enforceable under applicable nonbankruptcy law." The District Court noted that the three-prong test must be applied on a case-by-case basis after a careful examination of the controlling annuity documents.

The two annuities held by the debtor easily satisfied the second and third prongs of the test since both annuities were "subject to a restriction on transfer…that is enforceable under applicable nonbankruptcy law" by virtue of N.J.S.A. 17B:24-7. This state law protects annuities from the claims of creditors and forms the basis of both the restriction and applicable nonbankruptcy law. The issue was therefore narrowed to whether the annuities qualify as trusts.

The court looked to the Restatement of Trusts, which defines a trust as,

> a fiduciary relationship with respect to property, arising from a manifestation of intention to create that relationship and subjecting the person who holds title to the property to duties to deal with it for the benefit of charity or for one or more persona, at least one of whom is not the sole trustee.

Relying upon this definition, the District Court found that to qualify as a trust, four elements must be established:

> (1) a manifestation of intention to create a trust; (2) trust *res*; (3) a trustee who is bound by a fiduciary duty to deal with the property for another's benefit; and (4) a division of title between the trustee who holds legal title to the property and the beneficiary who retains equitable title.

At the bankruptcy court level, the court noted that "one of the most important things about a trust is how do the people who created the property right deal with it? How did they describe it?" The bankruptcy court reviewed the two annuity contracts separately, but came to the same conclusion: neither one was a trust. The annuity contracts did not use the word trust, the life insurance companies did not described themselves as trustees, and the contracts did not talk about beneficiaries in the "sense of them holding property for the benefit of someone under a trust." The bankruptcy court performed a more detailed analysis of each annuity contract and found no indicia of a trust

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relationship. For example, in the AMEX annuity contract, the words "flexible long terms savings plan" are used to describe the plan, the funds given to AMEX are not required to be held in a separate account, and the payments under the plan are "contractually guaranteed" indicating that the relationship was not one of trust. In affirming the decision, the District Court noted many of the same factors and found that the documents created a contractual debtor-creditor relationship, not a trust.

The second annuity (GIAC Annuity) was a closer call because the funds were actually held in a separate account and involved what appeared to be "division of title" which, in some jurisdictions, conclusively establishes that an asset is a trust. *See, In re Barnes*, 264 B.R. 415 (Bankr. E.D. Mich. 2001). However, other factors weighed against the finding of a trust, including the fact that the agreement was referred to as a contract (not a trust), the documents did not indicate that GIAC was assuming the role of a trustee, and there was no "res" since it appeared that GIAC had access to the funds being held in the separate account.

The debtor relied chiefly on *In re Shuster*, 265 B.R. 701(Bankr. D.N.J. 2000), a case that found that an annuity qualified for exemption under Bankruptcy Code § 541(c)(2). The court in *Shuster* relied upon the same law, but came to a different conclusion. The *Shuster* case is somewhat difficult to reconcile because the exact terms of the annuity contracts are not set forth in the written opinion. However, the holding has come into question in light of a recent decision by the same judge who held that annuities issued by Sun Life Assurance Company of Canada and New England Financial were not trusts entitled to exclusion under Bankruptcy Code § 541(c)(2). *See In re Vincent John Venutolo*, bankruptcy case no. 05-55232 (Bankr. N.J. Aug. 21, 2006, transcript filed Nov. 1, 2006). The *Venutolo* bankruptcy court relied upon the same legal authority as *Shuster*, but reached a different conclusion after a detailed analysis of the annuity contracts in question.

The *Hill* decision involved the attempted exclusion of an asset under Bankruptcy Code § 541(c)(2). However, the Chapter 7 Trustee also sought a declaration that the annuities are not exempt or, if exempt, fixing the amount of the exemption (Count III of the Trustee's complaint). The parties did not move for summary judgment on Count III of the complaint and, at this point, the debtor has not sought to amend Schedule C (Exemptions). It is interesting to note that the trustee in *In re Venutolo* is continuing with the exemption litigation since the debtor in that case is over 70 years old and is alleging that the annuities are exempt under Bankruptcy Code § 522(d)(10)(E). Under Bankruptcy Code § 522(d)(10)(E), a debtor may exempt payments under an annuity to the extent "reasonably necessary for the support of the debtor and any dependent of the debtor." 11 U.S.C. § 522(d)(10)(E).

It is likely that most annuities will fall into the "debtor-creditor" category and become property of the bankruptcy estate. Unless insurance companies are willing to take on the fiduciary responsibilities of a trustee and create a trust res to be separately held for the benefit of its customers, most annuities will not meet the definition of a trust. However, the battle over the ownership and control of an annuity does not end with the exclusion issue — exemption is still available in most cases. A debtor who has an interest in a valuable annuity may be better off selecting the state exemptions under Bankruptcy Code § 522(b)(2), which will enable the debtor to take full advantage of N.J.S.A. 17B:24-7, especially if the debtor does not need the federal homestead exemption. In the case of elderly or disabled debtors, an exemption under Bankruptcy Code § 522 (d)(10)(E) may be available if the annuity payments are reasonably necessary for the debtor's support. ■