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## THE DISABILITY PAY EXEMPTION MEETS FOSTER

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A CLE Presentation

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## A. Introduction

Exemptions for property under Indiana law have been consistently narrowed in recent years. The Indiana Supreme Court began the trend in its decision in *Matter of Zumbrun*, 626 N.E.2d 452 (Ind. 1993). The Court in *Zumbrun* determined that the Indiana statute providing for an exemption in a retirement account was unconstitutional. The unlimited amount that a debtor could shield from creditors was of concern. The same concern caused the Court to determine that the statute allowing “debtors to shield an unlimited amount of assets in a life insurance policy or policies” was constitutionally suspect. *Citizens National Bank of Evansville v. Foster*, 668 N.E.2d 1236, 1242 Ind. 1996). The Court determined that the exemption “may be claimed only upon proof that the exemption is required to afford the ‘necessities of life.’” The Bankruptcy Court that had sought certification to the Court on the question of the constitutionality of the statute had disallowed the exemption. *In re Foster*, 168 B.R. 183 (Bankr.S.D.Ind. 1994).

## B. Exemption Challenges Under Indiana Constitution

*Matter of Zumbrun*, 626 N.E.2d 452 (Ind. 1996) presented to the Indiana Supreme Court the question: “Does Indiana Code 34-2-26-1(a)(6) violate Article I, Section 22 of the Indiana Constitution by failing to impose any limitations upon the dollar value or amount of property which may be exempted and/or by failing to contain any requirement that the exempted property have a reasonable relation to the needs of the debtor for the support of himself and his family?” *Id.* at 453.

Article I, Section 22 of the Indiana Constitution reads in part: “The privilege of the debtor to enjoy the necessary comforts of life, shall be recognized by wholesome laws, exempting a reasonable amount of property from seizure or sale for the payment of any debt or liability....” Before amendment, Indiana Code 34-2-28-1(a)(6) exempted “[a]n interest the judgment debtor has in a pension fund, a retirement fund, an annuity plan, an individual retirement account, or a similar fund, either private or public.” Ind. Code Ann. § 34-2-28-1(a)(6) (West Supp. 1991).

The Zumbruns claimed as exempt \$3600 they held in an Individual Retirement Account (IRA) pursuant to Section 34-2-28-1(a)(6). The trustee argued that this statute violated Article I, Section 22, because this unlimited exemption shielded more than a “reasonable amount of property.”

The Court looked to “the history of the adoption of Section 22, the subsequent judicial interpretations of Section 22, and the more than 100 years of legislative enactments under its authority” to answer the question before it. *Zumbrun*, 626 N.E.2d at 453. The Court drew three conclusions from its analysis:

First, Section 22 commands the legislature to enact exemptions. Second, Section 22 requires statutes which define the exemptions in reasonably tangible ways so as to balance the interests of lenders and debtors. Third, statutes which create unlimited exemptions are inconsistent with the directive of Section 22 and the balanced policy underlying it. *Id.* at 455.

Examining the exemption in question using these criteria, the court concluded that the statute “exempted an unlimited amount of intangible assets from execution to pay legitimate debts, making it possible to closet virtually every liquid asset possessed by a debtor simply through placing the assets in some form of retirement instrument” and was therefore unconstitutional. *Id.*

The decision in *Zumbrun* was “presaged” by a decision rendered in the Southern District of Indiana, *In re Garvin*, 129 B.R. 598 (Bankr.S.D.Ind. 1991). In the *Garvin* case, the Court found Ind. Code § 34-2-28-1(a)(6) to be per se unconstitutional under the Indiana Constitution. *Id.* at 604. The statute “grant[ed] a far greater exemption than is necessary to enable a debtor to enjoy the necessary comforts of life. ... [It] simply exempts an unreasonable amount of property.” *Id.*

*In re Foster*, 168 B.R. 183 (Bankr.S.D.Ind. 1994) dealt with another claim that an exemption provided by an Indiana statute violated Article I, Section 22. The trustee argued that Indiana Code 27-1-12-14 provided an unlimited exemption of the sort invalidated in *Zumbrun*. Section 27-1-12-14(e) provides:

all policies of life insurance upon the life of any person, which name as beneficiary, or are bona fide assigned to, the spouse, children, or any relative dependent upon such person, or any creditor, shall be held, subject to change of beneficiary from time to time, if desired, for the benefit of such spouse, children, other relative or creditor, free and clear from all claims of the creditors of such insured person or of the person's spouse; and the proceeds or avails of all such life insurance shall be exempt from all liabilities from any debt or debts of such insured person or of the person's spouse. IC 27-1-12-14(e) (West Supp. 2002)

The trustee also challenged the debtors' claimed exemption of their IRAs. The Fosters claimed an exemption based on the then-current statute, Indiana Code 34-2-28-1(a)(6).<sup>1</sup> The amended statute provided an exemption for:

An interest, whether vested or not that the ... debtor has in a retirement plan to the extent of:

(A) Contributions ... that were made to the retirement plan:

(i) By or on behalf of the debtor; and  
(ii) Which were not subject to federal income taxation to the debtor at the time of the contribution;

(B) Earnings on contributions made under clause (A) that are not subject to federal income taxation at the time of the judgment; and

(C) Roll-overs of contributions made under clause (A) that are not subject to federal income taxation at the time of the judgment. I.C. 34-2-291(a)(6) (West Supp. 2002)

Roland Foster purchased a whole life insurance policy on November 18, 1993, for a single cash premium of \$100,000. The face amount of the policy was \$115,000, with a stipulated surrender value of \$91,846. The Fosters filed for relief under Chapter 11 on November 30, 1993. They claimed the life insurance policy exempt under I.C. 27-1-12-14(e). In addition they had IRAs valued at \$34,797.25 and \$31,799.75 at the time of the filing that they claimed as exempt under I.C. 34-2-28-1(a)(6). The trustee objected to both claims.

The *Foster* court relied on *Zumbrun* to invalidate the statute exempting life insurance policies. The statute "exempted an unlimited amount of intangible assets from execution to pay legitimate debts" and was therefore unconstitutional. *In re Foster*, 168 B.R. at 186. The debtors' exemption for the life insurance policy was denied. The court, however, upheld the claimed exemption for the IRAs. The court found that the amended statute, with its provision that contributions to the fund must be exempt from federal taxation, provided a reasonable cap to the exemption "and thus satisfies the *Zumbrun* criteria." *Id.* at 186-87.

On appeal the district court certified the question of the constitutionality of I.C. 27-1-12-14(e) and I.C. 34-2-28-1(a)(6) to the Indiana Supreme Court. *Citizens Nat'l Bank of Evansville v. Foster*, 668 N.E.2d 1236, 1239 (Ind. 1996). The court upheld the exemption for retirement accounts and found the exemption for life insurance policies to be constitutionally suspect.

The court noted that the amended exemption statute for retirement accounts did not allow a debtor to shield an unlimited amount of assets. Although "[t]he present Indiana statute does not contain its own cap on exemptible amount[,] it makes explicit reference to an amount certain and readily ascertainable in the Internal Revenue Code." *Id.* at 1240.

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<sup>1</sup> Indiana Code 34-2-28-1 was repealed and replaced by IC 34-55-10-2. The wording is identical. Section 131 defines "Retirement plan", for purposes of IC 34-55-10, to include: (1) a stock bonus, a pension, a profit sharing, an annuity, or a similar plan or arrangement, including a retirement plan for self-employed individuals or a simplified employee pension plan; (2) a government or church retirement plan or contract; or (3) an individual retirement annuity or individual retirement account; that is intended in good faith to qualify as a retirement plan under applicable provisions of the Internal Revenue Code of 1986, as amended. IC 34-2-6-131 (West Supp. 2002).

Petitioners argued that the amended statute was still unconstitutional “because the State has not demonstrated that the limited exemption is related to a debtor’s enjoyment of ‘the necessary comforts of life.’” *Id.* at 1241. The court rejected the argument, stating:

So long as the legislature articulates some limitation, it is the burden of the party seeking to invalidate a statutory exemption to demonstrate that the limitation does not go far enough for constitutional purposes. *Cf.* Bankruptcy Code § 522(c) and comment to the Collier’s 1995 Pamphlet Edition, Part 1, at 459. Thus, [petitioner] must overcome the presumption that pegging the amount of the exemption for IRAs to the limited federal income tax deduction is sufficiently related to the debtors’ enjoyment of “the necessary comforts of life.” It has failed to meet this burden. *Id.*

The court then turned to the constitutionality of the exemption for life insurance policies. It began by noting that certified questions pose problems for the court. First, courts do not like to decide an issue on constitutional grounds unless “no non-constitutional grounds present themselves for resolving the case.” *Id.* “[I]n this case, the certified question arises even though there exist other unresolved non-constitutional grounds on which the case might be resolved.” *Id.*

The second problem posed by certified questions is that “such questions tend to separate the constitutional claim from the specifics of the case.” *Id.* at 1242. It was with these issues in mind that the court pulled back from its bright line rule in *Zumbrun*. Rather than invalidating any statute that provided for an unlimited exemption, the court preferred to review the “constitutional validity of statutes as they are applied to particular parties in a case before” the court. *Id.* Therefore, “[t]he exemption for life insurance is constitutionally suspect and may be claimed only upon proof that the exemption is required to afford the ‘necessities of life.’” *Id.*

” *In re Bannourah*, 201 B.R. 954 (Bankr.S.D.Ind. 1996) did “delve into the admittedly murkier waters of reasonable necessity.” *Id.* at 955. The Court read *Foster* as requiring the debtor to prove that the claimed exemption was required to afford the “necessities of life.” *Id.* A certified public accountant calculated the debtor’s projected expenditures for the necessities of life over an eighteen-year period, using the national standard expenses taken from the IRS. The expenses less income left a deficit in excess of the value (\$200,000) of the proceeds of a life insurance policy. “Under these circumstances, the Court finds that the entire life insurance policy is exempt because it is related to the Debtor’s necessities of life.” *Id.*

### **C. Insurance Disability Payments and The Necessities of Life Exemption**

In *In re Stinnett*, an unpublished decision from the Southern District of Indiana, examined another claim that an exemption statute violated Article I, Section 22. *In re Stinnett*, No. 00-70768 (Bankr.S.D.Ind. 2002). Here the trustee challenged a claim that post-petition disability payments were exempt under Indiana Code I.C. 27-8-3-23(b).

Stinnett was an insurance salesman for Northwestern Mutual Insurance Company. He had purchased five disability policies from Northwestern, and paid the premiums beginning in 1995. Stress stemming from legal and tax problems and a divorce led to a depressive disorder resulting in Stinnett’s disability. He filed for protection under a Chapter 7 bankruptcy, and at the time of filing was receiving \$11,000 a month insurance disability pay from Northwestern. From these monthly payments he was required to pay his ex-wife \$5,000 a month pursuant to a divorce decree.

The debtor argued that disability payments are akin to future income. As 11 U.S.C. § 541(a)(6) specifically exempts from property of the estate “such as are earnings from services performed by an individual debtor after commencement of the case,” the disability payments should be exempt. Debtor only received the payments upon a showing of disability, and payments were received in lieu of the debtor’s regular income. The payments would terminate upon a determination that his disability has abated, his re-employment, achieving the age of 65, or his death.

The debtor argued that to allow the trustee to attach the post-petition disability checks to satisfy pre-petition debts would effectively force him into a quasi-Chapter 13. See *In re Harter*, 10 B.R. 272 (Bankr. N.D. Ind. 1981). There is an obvious appeal for this proposition. Debtor's post-petition income is not property of Chapter 7 estate. It would follow that disability payment, which are substitutes for earned income, would also be exempt.

The Congressional intent to exclude future income of this nature from the bankruptcy estate is further paralleled and amplified by the terms of the exemption provisions of 11 U.S.C. § 522. Under both Federal and Indiana law an individual debtor may exempt "[t]he debtor's right to receive a disability, illness, or unemployment benefit." 11 U.S.C. § 522(d)(10)(C) and I.C. 27-8-3-23. This exemption right has been recognized in numerous cases on the basis that the "benefits are akin to future earnings." *In re LaBelle*, 18 B.R. 169 (Bankr. D. Me. 1982) (Workers' compensation benefits); *In re Evans*, 29 B.R. 336 (Bankr. D. N.J. 1983) (Temporary disability benefits); *In re Cain*, 91 B.R. 182 (Bankr. N.D. Ga. 1988) (Workers' compensation disability). In discussing section 522(d)(10) Congress used the following language: "Paragraph 10 exempts certain benefits that are akin to future earnings of the debtor" ... H.R. 595 95<sup>th</sup> Cong. 1<sup>st</sup> Sess. 362 (1977), U.S. Code Cong. & Admin. New 1978, P. 5787, 6318.

The debtor next argued that even if disability payments were not exempt as a sort of "future earnings," the exemption provided by I.C. 27-8-3-23 was not constitutionally suspect and the exemption should be allowed. Indiana Code 27-8-3-23 provides in part:

The money or benefit provided or rendered by any corporation, association, or society authorized to do business under this chapter shall not be liable to attachment by garnishee or other process, and shall not be seized, taken, appropriated, or applied by any legal or equitable process, nor by any operation of law, to pay any debt or liability of a policy or certificate holder or any beneficiary named therein. I.C. 27-8-3-23(b).

The debtor argued that *Zumbrun* and *Foster*, with their concern for unlimited exemptions, were not applicable to disability payments. The court in *Foster* decided that an unlimited exemption, while constitutionally suspect, was not dispositive by itself. The court was concerned with an exemption that allowed a debtor to closet substantial sums in anticipation of bankruptcy. The disability policy owned by Stinnett was begun years before filing for bankruptcy, and there was no claim that he did so to shield assets. In addition, an impartial third party, the insurance company, has to reach the determination that the debtor is disabled before he can begin to receive payments. These aspects of disability insurance would seem to overcome the *Foster* court's concern that an exemption would allow a debtor to shield assets from his creditors.

Noting that Stinnett had been receiving additional disability from another policy, post position, the court in entered an order directing that the disability pay proceeds from the Northwestern policy, above the amount paid to Stinnett's former wife, would be retained by the trustee. Order, *In re Stinnett*, No. 00-70768, at \*1 (March 4, 2002). The court determined that the analysis required by *Foster* was appropriate to resolve the case. It implicitly determined that the disability payments were not "future earnings" exempt under 11 U.S.C. § 541(a)(6), but with limitations. Rather, it determined that the exemption provided by I.C. 27-8-3-23 was limited by the amount required for the reasonable necessities of life.

The *Stinnett* decision is one of first impression, and it extends to *Foster* "reasonable necessities test" to an additional exemption code. Disability payments are not "future earnings" protected by 11 U.S.C. § 541(a)(6). If Congress felt that they were protected by § 541(a)(6) there would have been no need to provide a separate exemption for disability payments under § 522(d)(10)(C) and (E). As Indiana opted out of the federal exemptions, the court looked at the constitutionality of the Indiana exemption statute.

Both *Foster* and *Zumbrun* discussed the need to balance the rights of the debtor and creditor when crafting an exemption. This balance requires some sort of limitation on an exemption. Because the legislature placed no cap on the amount of the exemption for disability payments, either implicitly or explicitly, the court examined what was required for *this* debtor to enjoy the reasonable necessities of life.

Once it was determined that disability payments are part of the estate, subject to the claimed exemption, the court determined that *Foster* calls for this type of analysis.

The Fourth Circuit Court of Appeals decided a case that provides inferential support for the decision in *Stinnett*. *In re Moorehead*, 283 F.3d 199 (4th Cir. 2002). The court was presented with the question if disability payments were fully or partially exempt under West Virginia law. West Virginia Code § 38-10-4(j) is identical to 11 U.S.C. § 522(d)(10). Subsection (j)(3) exempts the debtor's right to receive "a disability, illness or unemployment benefit," while (j)(5) exempts "payment under a stock bonus, pension, profit sharing, annuity or similar plan or contract on account of illness, disability, death, age, or length of service, to the extent reasonably necessary for the support of the debtor and any dependent of the debtor ..." (emphasis added).

The court had to determine if the privately purchased insurance was fully exempt under subsection (j)(3) or partially exempt under subsection (j)(5). See also *In re Bari*, 43 B.R. 253, 255 (Bankr.D.Minn. 1984) (classifying disability payments from an employer as partially exempt under Minnesota exemption modeled on 11 U.S.C. § 522(d)(10)(E)); *Sanders v. Sanders*, 711 A.2d 124, 128 (Me. 1998) (classifying payments under disability insurance policy as partially exempt under Maine exemption statute modeled on 11 U.S.C. § 522(d)(10)(E)). These cases lend support to the proposition that disability payments are not future income but are part of the estate subject to applicable federal or state exemptions, if any.

In resolving the issue if a disability payment was fully or partially exempt, the *Moorehead* court "believe[d] ... that the West Virginia legislature classified various types of benefits and payments as fully or partially exempt in § 38-10-4(j) by making assumptions about whether these benefits and payments would be limited to amounts reasonably necessary for the support of the debtor and his dependents." *Moorehead*, 283 F.3d at 207. The benefits that are fully exempt under subsections (j)(1)-(3) "could be assumed to be no more than an amount reasonably necessary for the support of the debtor," while the benefits partially exempt under subsections (j)(4),(5) "have the potential in some cases to exceed greatly what is reasonably necessary." *Id.* at 206, 207.

The court noted that the payments here were \$10,000 a month, increasing to \$13,000 a month for a cost-of-living allowance. "These amounts might be reasonably necessary to maintain the lifestyle to which the Mooreheads had been accustomed, but the standard of reasonable necessity in bankruptcy law is a more modest one." *Id.* at 207. Therefore, a debtor could fully exempt the proceeds from a privately purchased disability insurance policy only upon showing that the amount, met reasonable necessities.

#### **D. Conclusion**

Statute that provides an unlimited exemption for such pay is constitutional suspect and thus one "reasonable necessities" test described in *Foster* will be affirmed to determine the allowable part of the exemptions.