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# COMMERCIAL, BANKING & BANKRUPTCY LAW

The newsletter of the ISBA's Section on Commercial, Banking & Bankruptcy Law

## Bankruptcy may sound death knell for subsequent civil action

By *Micahel J. Marovich*

A potential client comes to your office to discuss a possible new civil case that he seeks representation on. He tells you that he wishes to file a civil matter seeking money damages against some person or company and asks if you will handle it for him. It sounds promising to you and you begin to take some background information. You discuss whether or not he has ever filed prior litigation and he replies that he just got done with a bankruptcy case earlier in the year. You don't feel it is of any great significance, so you move on. After the recent ruling in *Cannon-Stokes v. Potter*, 453 F.3d 446 (7th Cir. 2006) you may wish to re-think the taking of the case.

In *Potter*, Traci Cannon-Stokes contended that the U.S. Postal Service had violated the Rehabilitation Act, 29 U.S.C. Sec. 791, when they hired her as a letter carrier, by not accommodating her mental condition which

precluded her from making residential deliveries. To compound problems, Stokes contended that the Post Office retaliated against her for asserting her rights. While she was pursuing an administrative claim in which she sought \$300,000 against the U.S. Postal Service, she filed a Chapter 7 bankruptcy petition. The bankruptcy petition that she filed expressly denied that she had any valuable legal claims. Based upon this assertion, the bankruptcy court discharged her unsecured debts which totaled nearly \$98,000. After her bankruptcy case finished, she filed her lawsuit against Mr. Potter who was the Postmaster General of the U.S. Postal Service. The trial court, ultimately, dismissed the lawsuit against the Post Office stating that the doctrine of judicial estoppel demanded the result. The court ruled as such despite the fact that Ms. Stokes claimed that she was simply following her bankruptcy attorney's advice in not declaring this asset. The court even noted that her bankruptcy attorney was known for unethical tactics and had been banned from practicing in either state or federal court. The court found that "the remedy for bad legal advice lies in malpractice litigation against the offending lawyer." The court noted that all six federal appellate courts have held that "a debtor in bankruptcy who denies owning an asset, including a chose in action or other

legal claim, cannot realize on that concealed asset after the bankruptcy ends." The court stated that such a ruling is mandated because:

By making [litigants] choose one position irrevocably, the doctrine of judicial estoppel raises the cost of lying. A doctrine that induces debtors to be truthful in their bankruptcy filings will assist creditors in the long run (though it will do them no good in the particular case) - and it will assist most debtors too, for the few debtors who scam their creditors drive up interest rates and injure the more numerous honest borrowers. Judicial estoppel is designed to 'prevent the perversion of the judicial process,' a fair description of the result if we were to let Cannon-Stokes conceal, for her personal benefit, an asset that by her reckoning is three times the value of the debts she had discharged. It is impossible to believe that such a sizeable claim - one central to her daily activities at work - could have been overlooked when Cannon-Stokes was filling in the bankruptcy schedules. And if Cannon-Stokes were really making an honest attempt to pay her debts, then as soon as she

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realized that it had been omitted, she would have filed amended schedules and moved to reopen the bankruptcy, so that the creditors could benefit from any recovery. Cannon-Stokes never did that; she wants every penny of the

judgment for herself.

Based upon all the above, the 7th Circuit Federal Appeals Court affirmed the dismissal of the claim against the defendant based upon the application of the doctrine of judicial estoppel. As such, it would be wise for us all, in our

early investigations of any civil claim, to determine if a bankruptcy filing was made by the potential client, and, if there were, to obtain a copy of the filed schedules if the current claim could have been listed as an asset.

## Federal court denies protection in bankruptcy for inherited IRA

By Robert S. Held and Vasili D. Russis

**A bankruptcy court, applying Illinois law, held that a debtor's interest in an inherited IRA was not exempt from the claims of the debtor's creditors. Practitioners must beware that non spousal inherited IRAs may not receive the creditor protection applicable to retirement assets once thought to exist under Illinois law.**

A recent bankruptcy court decision calls into question the creditor protection benefits of an individual retirement account ("IRA") inherited by a non-spouse beneficiary. Until the decision, *In re Taylor*, 2006 WL 1275400 (Bkrtcy.C.D.Ill), creditor protection benefits afforded to IRA owners also appeared to extend to the owners of inherited IRAs. But the bankruptcy court ruled in May that an inherited IRA—unlike a self-created IRA—does not receive protection from the creditors of the bankruptcy estate. If followed, this case of first impression means that non-spouses that inherit an IRA may not receive protection in bankruptcy for such funds.

During the *Taylor* bankruptcy proceeding, a debtor inherited her deceased aunt's IRA. The debtor promptly amended her bankruptcy filing to include the IRA as an asset of the bankruptcy estate, but also claimed an exemption. Retirement assets under Illinois state law (applicable in federal court) generally are exempt from the claims of creditors, including those in bankruptcy. The trustee in bankruptcy, while recognizing the retirement exemption, countered by emphasizing

a distinction between self-created IRA accounts and inherited IRA accounts. The trustee argued that Illinois law provides that only IRAs that are exempt from federal tax are exempt in bankruptcy. Seeking to obtain the IRA assets for the creditors, she argued that IRAs are tax-exempt, but not inherited IRAs. While other bankruptcy courts had reviewed this issue recently,<sup>1</sup> this was the first case applying Illinois law as a sword to subject an inherited IRA to the claims of creditors.

The Court held that Taylor's inherited IRA was not exempt under Illinois law and, therefore, was subject to the claims of her creditors in bankruptcy. The Court's rationale hinged on its interpretation of an Illinois statute that provides broad creditor protection for retirement accounts and annuities. The statute in question states,<sup>2</sup> in part, that "a debtor's interest in . . . the assets held in . . . a retirement plan is exempt from judgment . . . if the plan . . . is intended in good faith to qualify as a retirement plan under applicable provisions of the Internal Revenue Code of 1986."

The Court was convinced that inherited IRAs are not exempt from being taxed as gross income.<sup>3</sup> It made this finding because under the Internal Revenue Code non-spousal inherited IRAs cannot be rolled over into the beneficiary's own IRA.<sup>4</sup> Rather, a non-spouse IRA beneficiary must take out distributions over the life expectancy of the beneficiary.<sup>5</sup> The Court focused on this inability of a non-spouse IRA beneficiary to roll over the IRA and concluded that an inherited IRA is not "exempt from being taxed as gross income . . ."<sup>6</sup>

As noted supra, the Illinois legislature has elected to exempt retirement plans from the claims of creditors, including IRAs.<sup>7</sup> The statute requires only that a retirement plan be "intended in good faith" to qualify as a retirement plan. No distinction is made in the statute between an IRA and an inherited IRA. The good faith intention requirement under Illinois law has been reviewed previously by a bankruptcy court.<sup>8</sup> The *In re Ritter* decision provides that a presumption exists: an IRA owner has intended that an IRA qualify as a retirement plan if the account has been established in conformity with the technical requirements of the Internal Revenue Code. The debtor's use of funds for non-retirement purposes (living expenses) did not cause the IRA to lose its retirement plan status.<sup>9</sup> Unfortunately, a bankruptcy court in Alabama stated that "an inherited IRA is sufficiently different from an IRA" under the Internal Revenue Code because a non-spouse beneficiary is unable to roll over an inherited IRA (even though both grant deferrals from tax). That statement by the bankruptcy court may or may not be an important difference in Alabama; however, the *Taylor* court and the Illinois exemption statute do not make such a distinction. Moreover, the Illinois exemptions apply to Illinois residents who file for bankruptcy.<sup>10</sup>

The *Taylor* court was blunt; it ruled that the debtor's inherited IRA was not intended in good faith to qualify as a retirement plan. The Court made two points in support of this surprising conclusion. First, as noted, an inherited IRA is not exempt from being taxed as gross income because it may not be rolled

over (by a non-spouse beneficiary). Second, once an IRA is inherited, the beneficiary may not make contributions to the account. The Court's reasoning is questionable on both points.

Although an inherited IRA cannot be rolled over, an inherited IRA is granted a deferral, and not an exemption, from income taxes on the same basis as an IRA. Upon the death of the owner of an IRA, a beneficiary is not taxed on the value of the IRA funds in the year of death. The IRA beneficiary, generally, may take out the value of the IRA funds as income over his or her own life expectancy.<sup>11</sup> Such a distribution schedule provides for a deferral from tax, not an exemption.

The Court thus exacerbated its questionable logic by using the wrong term to describe an income tax concept applicable to all IRAs—income tax deferral. No traditional IRA, whether an inherited IRA or self-created IRA, is ever exempt from tax. Rules for all IRAs provide for the distribution and taxation of funds so held—it is the deferral period that may vary slightly.

The Court's focus on differences between a self-created IRA and one which is inherited is misplaced. The Illinois statute, "Exemption for Retirement Plans," 735 ILCS 5/12-1006, makes no distinction between the two types of IRAs. Further, as shown in *Ritter*, an inherited IRA is presumed to qualify as a retirement plan under Illinois law. As such, the Court's decision is difficult to reconcile with both the literal language of the statute and the intent of the Illinois legislature. The literal language of the statute and the applicability of the exemption to those who come into pension rights derivatively was recognized in a prior bankruptcy case, *In re Lummer*, 219 B.R. 510 (Bkrtcy.S.D. Ill 1998).

In *Lummer*, a divorced debtor who held an interest in her former husband's military pension filed for bankruptcy and then had to defend against the trustee's objection to the claimed exemption. The Court overruled the trustee's objection and summarized the reach of the Illinois statute: "Had the Illinois legislature wished to restrict the coverage of this section to debtors who earn pension rights as the fruit of their own labor, it could have done so easily. Instead, the statute is drawn broadly and is devoid of any suggestion that its scope excludes debtors who have come

into their pension rights derivatively."<sup>12</sup>

Further, the *Taylor* court also proclaims that a beneficiary may not make any contributions to an inherited IRA.<sup>13</sup> However, neither Illinois law nor the Internal Revenue Code state or imply that the ability to make contributions to an IRA is a factor in the qualification of an IRA as a retirement plan.

Two cases cited by *Taylor*, an Alabama and Oklahoma<sup>14</sup> opinion, provide scant support for the *Taylor* court's ruling. Those cases evidence a lack of understanding of the income tax rules that allow deferral from taxation for inherited IRAs. First, *Sims*, the Oklahoma case, improperly claims that "the IRA (in the hands of the debtor) is no longer a tool to defer taxation on income in order to provide for retirement."<sup>15</sup> *Sims* incorrectly assumes that the debtor has to withdraw the inherited IRA over a five-year period, as opposed to taking distributions over the life expectancy of the debtor.<sup>16</sup> *Navarre* states that an inherited IRA is sufficiently different from a spousal-inherited IRA; however, the court in *Navarre* believed that the roll over provision for spouses<sup>17</sup> is the only method to allow for deferral of income tax after the death of the IRA owner. Yet, as noted, a beneficiary of an inherited IRA can defer taxes over his or her life expectancy without qualifying for rollover treatment.<sup>18</sup>

The *Taylor* court also ignored the holding in *Auto Owners Ins. v. Berkshire*.<sup>19</sup> There, the Court found that funds transferred from a retirement account to a checking account can remain exempt from the reach of creditors. Logically, IRA funds inherited by a non-spouse should not lose their exempt status as well.

The *Taylor* court takes a position that a non-spouse inherited IRA is subject to a creditor's claims while creditor protection is available in many analogous circumstances. An obvious example is a spendthrift trust created for a child.<sup>20</sup> Also, when an annuitant dies, the payments to the beneficiary also are not subject to the claims of creditors. It is puzzling that an IRA inherited from a decedent should be treated differently than a spendthrift trust or an annuity, or for that matter, a self-created IRA.

One point to ponder is the effect of a conversion to a Roth IRA.<sup>21</sup> Distributions from a Roth IRA are not subject to tax.<sup>22</sup> A Roth IRA thus could

meet the criteria set forth by the *Taylor* Court, albeit flawed, that funds in the account are exempt from tax. Although there is no case on point, if the inconsistent reasoning of *Taylor* is adopted by other courts, it may behoove investors to consider converting traditional IRAs into Roth IRAs or simply to establish a Roth IRA in preference to a traditional IRA.

While other bankruptcy judges may reach a different conclusion than the *Taylor* court, Illinois practitioners should beware. Asset protection planners must now assume that a non-spouse inheriting an IRA will lose his or her protection from the claims of creditors, notwithstanding existing law on this point.

1. *In re Greenfield*, 289 B.R. 146 (Bkrtcy. S.D.Cal.,2003) (inherited IRA could not be claimed as exempt under California exemption for debtor's right to receive payment under any "stock bonus, pension, profit sharing, annuity or similar plan or contract").

2. 735 ILCS 5/12-1006.

3. Slip Copy, *In Re Taylor*, 2006 WL 1275400 \*2 (Bkrtcy.C.D.Ill).

4. Internal Revenue Code §408(d)(3)(C).

5. Treas. Reg. A-5 of §1.401(a)(9)-5.

6. *Taylor*, 2006 WL 1275400 \*2.

7. 735 ILCS 5/12-1006 states, in part, as follows: "Exemption for retirement plans.

(a) A Debtor's interest in or right, whether vested or not, to the assets held in or to receive pensions, annuities, benefits, distributions, refunds of contributions, or other payments under a retirement plan is exempt from judgment, attachment, execution, distress for rent, and seizure for the satisfaction of debts if the plan (i) is intended in good faith to qualify as a retirement plan under applicable provisions of the Internal Revenue Code of 1986, as now or hereafter amended, or (ii) is a public employee pension plan created under the Illinois Pension Code, as now or hereafter amended.

(b) "Retirement plan" includes the following:

(3) an individual retirement annuity or individual retirement account; and

(4) a public employee pension plan created under the Illinois Pension Code, as now or hereafter amended.

(c) A retirement plan that is (i) intended in good faith to qualify as a retirement plan under the applicable provisions of the Internal Revenue Code of 1986, as now or hereafter amended, or (ii) a public employee pension plan created under the Illinois Pension Code, as now or hereafter amended, is conclusively presumed to be a spendthrift trust under the law of Illinois."

8. *In re Ritter*, 190 B.R. 323 (Bkrtcy.

N.D.Ill., 1995) (possibility of income tax liability for early withdrawals of funds from IRA account did not destroy exemptions under Illinois law).

9. *Id.*

10. See 11 U.S.C. §522(b)(1) and 735 ILCS 5/12-1201.

11. I.R.C. §401(a)(9).

12. *Lummer*, 219 B.R. at 512 (scope of Illinois exemptions in bankruptcy does not exclude debtors who have come into their pension rights derivatively)

13. Slip Copy, *In Re Taylor*, 2006 WL 1275400 \*2 (Bkrtcy.C.D.Ill).

14. *In re Sims*, 241 B.R. 467 (Bkrtcy.N.D.Okla., 1999) (Oklahoma exemption could not be utilized; statute that was designed to protect funds for retirement purposes could not properly be used to shield cash inheritance, which was available to party's son at son's will and without penalty, and which had to be taken by son well in advance of his own retirement age); *In re Navarre*, 332 B.R. 24 (Bkrtcy.M.D.Ala., 2004).

15. *In re Sims*; 241 B.R. at 470.

16. Treas. Reg. A-5 of §1.401(a)(9)-5.

17. I.R.C. §408(d)(3)(C).

18. See I.R.C. §408(d)(3)(C).

19. 225 Ill.App.3d 695, 588 N.E.2d 1230 (2nd Dist. 1992).

20. See 735 ILCS 5/2-1403, "No court . . . shall order the satisfaction of a judgment out of any property held in trust for the judgment debtor if such trust has, in good faith, been created by . . . a person other than the judgment debtor."

21. I.R.C. §408A.

22. I.R.C. §408A(d)(1).

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