

UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF NEW YORK

In re:

Chapter 7
Case No. 07-12685

JOHN W. BATTERSBY,
Debtor.

Appearances:

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MEMORADUM-DECISION AND ORDER

Before this court is the motion filed by Michael J. O'Connor, Chapter 7 Trustee, objecting to the claimed exemption of an \$85,000 settlement by John W. Battersby, debtor, under the Debtor and Creditor Law § 282(2)(e). It is Mr. Battersby's position that this settlement represents a "restorative payment" to an IRA account and is therefore eligible for exemption. The Trustee contends that this settlement is not an IRA account and, thus, not exempt within the plain meaning of the statute.

SUMMARY OF FACTS

Mr. Battersby, a Korean War veteran, spent over twenty years working as a lab technician for General Electric, retiring in 1993. While at GE, he accumulated approximately \$250,000 worth of GE stock for his retirement through weekly contributions to a stock sharing plan. In 1999, Mr. Battersby's grand-nephew, a broker with Gruntal & Co. in New York City, persuaded Mr. Battersby to allow him to manage his funds. The account stayed with Gruntal &

Co. until September 2000 when Mr. Battersby's nephew joined another firm, Legg Mason, Inc., and Mr. Battersby transferred his funds to the new firm opening an Individual Retirement Account ("IRA"). At the time of the transfer the account was valued at approximately \$260,000. Mr. Battersby also made a \$25,000 deposit to the account in June 2001 upon the sale of his home.

After moving his account to Legg Mason, Mr. Battersby's nephew began unauthorized and unsuitable trading and churning of Mr. Battersby's assets. By January of 2002, the value of Mr. Battersby's IRA had dropped to \$55,000. By September 2002, Mr. Battersby closed his Legg Mason account withdrawing his remaining funds. Upon closing the account, the fund was valued at \$20,739 and had lost approximately \$150,000 of value. Mr. Battersby did not open a new IRA account with the funds he removed from the Legg Mason account.

On May 14, 2006, Mr. Battersby, represented by Lincoln Square Legal Services ("Lincoln Square"),¹ filed an arbitration claim against Legg Mason and his nephew with the National Association of Securities Dealers ("NASD") seeking both compensatory and general damages for the unauthorized trading and churning of his assets. Meanwhile, Mr. Battersby filed for Chapter 7 bankruptcy protection on October 8, 2007 through We The People, a business that charges fees for preparation of legal documents. We The People is not licensed to practice law and may not give legal advice.

Mr. O'Connor was appointed Chapter 7 Trustee for Mr. Battersby's case and, upon learning of the NASD claim, applied to retain Lincoln Square to represent the bankruptcy estate in the settlement negotiations.² On February 7, 2007, the court appointed Lincoln Square as special counsel to represent the estate in the matter of the NASD claim.

¹ Lincoln Square is a clinical program operated by Fordham University School of Law. Its services were provided to Mr. Battersby pro bono.

² Lincoln Square also undertook this representation pro bono.

The parties ultimately agreed to settle the NASD claim for \$85,000. The Trustee subsequently made a motion for approval of the settlement of the NASD claim for \$85,000. He did not provide a copy of any written settlement agreement, but merely asked the court to approve a monetary figure. In his motion, the Trustee also noted that Mr. Battersby could seek to have the settlement proceeds deemed exempt and approved of him retaining counsel to pursue such ends, but retained his right to object to any such claimed exemption. The court approved the settlement on March 4, 2008, and recognized the Trustee's right to object to Mr. Battersby's proposed exemption of the settlement from the bankruptcy estate. On April 21, 2008, Mr. Battersby and legal counsel for Legg Mason signed the settlement agreement, but it was not assented to by the Trustee or any third party mediator, arbiter, or finder of fact. The settlement agreement held that the \$85,000 represented a return of principal taken from Mr. Battersby's IRA account. Upon reaching an agreement, Mr. Battersby opened a new IRA account in anticipation of depositing the settlement proceeds.

As of October 8, 2008, the court's claims' register indicates creditors' claims amounting to \$18,990.77. Thus, all claims could be paid from the settlement proceeds with a balance remaining for the debtor.

ARGUMENTS

On June 8, 2008, Mr. Battersby filed an amended petition and schedules, listing the \$85,000 settlement as exempt from the bankruptcy estate. On June 25, 2008, the Trustee filed a motion objecting to the claimed exemption. In his objection, the Trustee alleges that when Mr. Battersby filed his bankruptcy petition he did not have an extant retirement account and that the asset at issue was a "claim against the brokerage company" not "an IRA, 401k, or other ERISA-qualified asset." (Tr. Mot. Objecting to Claimed Exemptions, ¶10 (Bankr. N.D.N.Y. 2008) (No. 07-12685))

Mr. Battersby filed opposition to the Trustee's motion on August 28, 2008. Mr. Battersby asserts that the \$85,000 settlement is exempt from the bankruptcy estate by virtue of its status as a "restorative payment" of principal to an IRA account. Mr. Battersby bases this argument on wording in the settlement agreement with Legg Mason. Furthermore, Mr. Battersby argues that a restorative payment of principal should be exempt under the persuasive authority of a U.S. treasury regulation and a pair of IRS revenue and private letter rulings.

DISCUSSION

As the party objecting to the claimed exemption, the Trustee has the burden of proving that the \$85,000 settlement is not exempt. Fed. R. Bankr. P. 4003(c). "Under both New York and federal law, exemption statutes are liberally interpreted in favor of debtors." *In re Ruffo*, 261 B.R. 580, 583 (Bankr. E.D.N.Y. 2001) (citations omitted). Nevertheless, this maxim is "not an end unto itself and does not displace all other rules of statutory construction with regard to exemption statutes." *In re Lowe*, 252 B.R. 614, 620 (Bankr. W.D.N.Y. 2000). This rule of interpretation should only be resorted to in order to resolve an ambiguity, not to create one. *Id.*

Mr. Battersby's right to claim exemptions is controlled by § 522 of the Bankruptcy Code. New York State, however, has "opted out" of the federal exemptions scheme pursuant to 11 U.S.C. § 522(b). As a result, this court applies New York law in evaluating claimed exemptions from the bankruptcy estate, and the relevant statutes are Debtor and Creditor Law §§ 282–284. *Dubroff v. Harris*, 119 F.3d 75, 76–77 (2d Cir. 1997). In bankruptcy proceedings, Debtor and Creditor Law § 282(2)(e) exempts IRAs. *Id.* at 80. Section 282(2)(e) holds as follows:

Bankruptcy exemption for right to receive benefits. The debtor's right to receive or the debtor's interest in: (a) a social security benefit, unemployment compensation or a local public assistance benefit; (b) a veterans' benefit; (c) a disability, illness, or unemployment benefit; (d) alimony, support, or separate maintenance, to the extent reasonably necessary for the support of the debtor and any dependent of the debtor; and (e) all payments under a stock bonus, pension, profit sharing, or similar plan or contract on account of illness, disability, death, age, or length of service unless (i) such plan or contract, except those qualified

under section 401, 408 or 408A of the United States Internal Revenue Code of 1986, as amended, was established by the debtor or under the auspices of an insider that employed the debtor at the time the debtor's rights under such plan or contract arose, (ii) such plan is on account of age or length of service, and (iii) such plan or contract does not qualify under section four hundred one (a), four hundred three (a), four hundred three (b), four hundred eight, four hundred eight A, four hundred nine or four hundred fifty-seven of the Internal Revenue Code of nineteen hundred eighty-six, as amended.

N.Y. DEBT & CRED. LAW § 282(2)(e) (McKinney 2001) (footnotes omitted). Mr. Battersby would have the court interpret this provision liberally in his favor. In order to do this, however, the court must see ambiguity on the face of the statute. The court does not perceive any such ambiguity.

1. Mr. Battersby did not have an IRA account when he filed for bankruptcy

In order to have been eligible for the IRA exemption under § 282(2)(e), Mr. Battersby must have had an IRA at the time he filed his petition. It is at this time that a debtor's legal and equitable interest in property becomes property of the debtor's bankruptcy estate. *See In re Brown*, No. 06-30199, 2007 Bankr. Lexis 2486 (Bankr. N.D.N.Y. July 23, 2007); *In re Little*, No. 05-68281, 2006 Bankr. Lexis 1010, at 4-5 (Bankr. N.D.N.Y. Apr. 24, 2006); *In re Quackenbush*, 399 B.R. 845, 847 (Bankr. S.D.N.Y. 2006). The estate is to be strictly determined as of the petition date. *In re Orso*, 283 F.3d 686, 691 (5th Cir. 2002). Mr. Battersby filed for bankruptcy in October 2007. At that time, however, he no longer had an IRA, having closed his account with Legg Mason in September 2002. Furthermore, after closing the account, Mr. Battersby did not open a new IRA until after the settlement was reached. Absent evidence of the existence of an IRA account at the time of filing, this court cannot find that the \$85,000 settlement constituted funds exempt under § 282(2)(c).³

³ This outcome may have been avoided had Mr. Battersby sought legal counsel in preparing his bankruptcy filing. Although We The People and other document preparation services can provide a facially more affordable way to file for bankruptcy, it must be noted that their discounted price often comes at the expense of forgoing adequate legal advice.

2. *The \$85,000 settlement is not a return of principal for bankruptcy purposes*

Mr. Battersby presents the novel argument that as the \$85,000 settlement represents a return of principal from a former IRA account, it should fall within the exemption embodied in § 282(2)(c). Mr. Battersby has no case law to support this position, but does present authority in the form of treasury regulations, as well as revenue and private letter rulings from the IRS. Treas. Reg. § 1.415(c)-1(b)(ii)(C) (2007); Rev. Rul. 2002-45, 2002-2 C.B. 116; I.R.S. Priv. Ltr. Rul.200738025 (Jun. 26 2007). He also points out that the sum is designated as a return of principal in the settlement agreement between the parties. Had this truly been a return of principal (ideally deposited into the same IRA it had been removed from) the court would be hard pressed to deny Mr. Battersby's claims. Unfortunately, Mr. Battersby has not presented sufficient evidence showing this to be the case.

The treasury regulations and IRS rulings, while informative, are not binding on this court. These cases are not applicable because they deal with tax treatment of the settlement rather than its status as an exemption under either the Bankruptcy Code or New York law. The IRA exemption contains no allowance for "restorative payments," and the court is unaware of any other bankruptcy court reading an exception for restorative payments into the exemption.

Moreover, the settlement agreement, which denotes this payment as a return of principal, was prepared by representatives of Mr. Battersby and Legg Mason and never bore the imprimatur of either the Trustee or a third party finder of fact. The absence of the Trustee's assent to this agreement is notable, as the claim was an asset of the bankruptcy estate when the settlement was negotiated and reached. When the Trustee requested that this court approve of the settlement offer, he did not present the agreement to the court and, in fact, alleges that he was not aware of the terms therein. In short, there was no party to whom it ever had to be proven that this money was in fact a return of principal. Legg Mason had no interest in how the amount was

characterized, and Mr. Battersby had a clear interest in it being characterized as principal for favorable tax treatment and for potential exemption from the bankruptcy estate.⁴ As a result the court does not accept the agreement as proof that the settlement constituted a return of principal rather than payment of damages.

CONCLUSION

Although the court believes Mr. Battersby's victimization by his nephew and Legg Mason to be egregious and lamentable, it is clear that there is no justifiable basis under the statute for exemption of the settlement proceeds. The court finds that the \$85,000 settlement awarded to the estate for the illegal churning and unauthorized trading of Mr. Battersby's IRA funds does not fall within the exemption for IRAs under § 282(2)(e), as Mr. Battersby did not possess an IRA when he filed his bankruptcy petition and because there is no authority under which to characterize the payment as exempt.

It is SO ORDERED.

Dated: Albany, New York
January 13, 2009

/s/ Robert E. Littlefield, Jr.

Hon. Robert E. Littlefield, Jr.
Chief U.S. Bankruptcy Judge

⁴ It should be noted that the court is aware of Lincoln Square's conflict of interest in this matter as representative of the Trustee in negotiations with Legg Mason and then as representative of Mr. Battersby arguing that the settlement proceeds obtained from those negotiations are IRA principal warranting exemption. The court is satisfied that this conflict has been waived by the parties. (*See* Tr. Mot. Objecting to Claimed Exemptions, ¶8 (Bankr. N.D.N.Y. 2008) (No. 07-12685)) Nevertheless, the pall this conflict casts over the settlement negotiations leaves the court doubly reluctant to accept the agreement's designation of the settlement as a return of principal.