

**In re CHARLES PHILLIPS and JEAN PHILLIPS, Debtors.**

**Bankruptcy Case No. 96-33445BDM, Chapter 13**

**UNITED STATES BANKRUPTCY COURT FOR THE NORTHERN DISTRICT  
OF CALIFORNIA**

*206 B.R. 196; 1997 Bankr. LEXIS 249*

**March 4, 1997, Decided**

**March 4, 1997, FILED**

**SUBSEQUENT HISTORY:**

[\*\*1] As Amended March 17, 1997.

**DISPOSITION:**

Mayer's objections to Debtors' claim of exemption of assets in the Retirement Plan sustained.

**COUNSEL:**

For Scott and Kevin Mayer: Tobias S. Keller, Esq.,  
Murphy, Weir & Butler, San Francisco, CA.

For debtors: Matthew J. Shier, Esq., Poppin & Shier, San  
Francisco, CA.

David Burchard, Chapter 13 Trustee, Foster City, CA.  
Office of the United States Trustee, San Francisco, CA.

**JUDGES:**

Dennis Montali, United States Bankruptcy Judge

**OPINIONBY:**

Dennis Montali

**OPINION:**

[\*197] MEMORANDUM DECISION

I. Introduction

This case involves a clash of policies, pitting a tradition of generous California exemptions and a liberal attitude in favor of debtors who claim them against the time-honored notion that a person may not enjoy the use of his or her assets through a personal trust that attempts to insulate those assets from the trustor's creditors. This case also appears to be one of first impression, testing the limits of that liberal exemption policy by asking whether

the court will permit debtors to create an exemption all by themselves, virtually out of whole cloth, under the guise of a "private retirement plan." The parties have not presented the court with any reported cases that go as far as the debtors [\*\*2] wish. Were the court to adopt the debtors' theory of this case, it might just as well inform California creditors that there will be no more enforcement of judgments against individual debtors since all those debtors [\*198] need to do to frustrate their creditors' efforts is claim that they have planned the use of their assets for their later (retirement) years. The court will not do that.

Although debtors claim another time-honored right, namely the freedom to convert in good faith non-exempt assets to exempt assets on the eve of bankruptcy, they have no exemption available to them at all through what they call their private retirement plan; if they do, their plan was not designed and used for retirement purposes and cannot help them here.

II. Proceedings

A trial was conducted on January 3, 1997 in this Chapter 13 case on objections filed by Scott and Kevin Mayer (collectively "the Mayers") to confirmation of the Chapter 13 plan filed by Charles Phillips and Jean Phillips ("Debtors"). Trial was limited to the claim by Debtors that their Phillips Retirement Plan and Phillips Retirement Trust (together the "Retirement Plan") was exempt under California law. The parties agreed that [\*3] the determination of the exemption issue would influence whether or not the balance of Mayers' objections to confirmation of the Chapter 13 plan should be tried promptly or whether Debtors would have to revise their plan for further consideration.

Debtors appeared and were represented by Matthew J. Shier, Esq. of Poppin & Shier; Mayers appeared and were represented by Tobias S. Keller, Esq. of Murphy, Weir & Butler.

As indicated above, after reviewing the oral and documentary evidence presented and the pre- and post-trial authorities submitted by the parties, the court will sustain the Mayers' objections for the reasons stated below. n1

n1 Objections to exemptions are not the most direct way for a creditor to challenge confirmation of a Chapter 13 plan. Where exemptions are questioned, the more appropriate procedure is for the creditor to show that the value to be distributed under the plan on account of allowed unsecured claims is less than the amount that would have been paid if the debtor's estate were liquidated under Chapter 7. 11 U.S.C. § 1325(a)(4). The parties have agreed, however, that the court should consider the propriety of the claimed exemptions, not only to aid it and them in determining the "best interests" test of Debtors' Chapter 13 plan, but also because the validity of the claimed exemption would be in issue were the Debtors to dismiss their Chapter 13 case or convert it to Chapter 7.

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### III. Facts n2

n2 The following discussion constitutes the court's findings of fact and conclusions of law. Fed. R. Bankr. P. 7052(a).

As of the date of trial, Debtor Charles Phillips was 64 years old and self-employed. His wife, Jean Phillips, was 58 years old and employed as a registered nurse. They have been married for approximately 23 years and have no children.

Debtors purchased their first home, 1022 Powell Street, No. 1, San Francisco, California ("Powell Street") in 1977; they sold Powell Street to the Mayers in 1988. In 1986, Debtors purchased their current residence at 170 Ninth Avenue, San Francisco, California ("Residence").

Debtors contend that as early as 1977 they adopted an "informal retirement plan." There is no writing to evidence this intent and over the years they used several of the assets they purportedly transferred informally to

this plan for a variety of purposes, none directly related to their retirement.

In 1985, Debtors executed the Charles and Jean Phillips Revocable Trust [\*\*5] (the "Revocable Trust"), which was essentially a probate avoidance device and a technique for estate planning. There is nothing about retirement mentioned in the Revocable Trust. Rather, while Debtors (as trustors) are both alive, the Revocable Trust provides for them to reach the income and the principal of the trust for numerous non-retirement purposes. n3 They did not use the Revocable [\*199] Trust for retirement purposes. Powell Street is identified on Schedule A to the Revocable Trust as a trust asset, but there is no evidence that any deed transferring Powell Street to the trustees of the Revocable Trust was executed and recorded.

n3 Article III (Distribution of Income and Principal During Trustors' Joint Lifetimes), provides as follows:

A. As long as both Trustors are alive:

(1) The Trustee shall pay to either or both of the Trustors (as their community property) or apply for their benefit, in quarter-annual or more frequent installments, the net income of the community estate and also as much of the principal of the community estate as the Trustee deems appropriate for their support, comfort, health, education and general welfare, taking into account their accustomed standard of living and the availability to them of other resources.

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After Debtors purchased the Residence in 1986, they did not transfer it to the Revocable Trust. Subsequent to 1985, they used assets purportedly transferred previously for various purposes, including paying insurance expenses, making improvements at the Residence (expending as much as \$ 50,000 for structural work, kitchen remodeling, and the construction of a deck), and paying expenses in connection with the Mayers litigation. At least one mutual fund account said to be in the Revocable Trust was specifically denominated as a "non-retirement account." Debtors did not consistently treat the assets purportedly transferred in 1985 as retirement assets and in fact failed to disclose the existence of any such retirement plan on financial statements subsequently provided to the Mayers.

In 1993, the Mayers discovered facts which caused them to sue to rescind the sale of Powell Street. Thereafter, for approximately 2-1/2 years, the Mayers

and Debtors litigated that action in the Superior Court of San Francisco. On March 29, 1996, that court issued a tentative decision against the Debtors n4 and notified Debtors that it would enter judgment in favor of the Mayers. Not long after receipt of [\*\*7] the tentative decision, Debtors consulted with Poppin & Shier, a San Francisco bankruptcy law firm; not long after that consultation, Debtors consulted an estate planning specialist in the San Francisco law firm of Steinhart & Falconer. The documents creating the Retirement Plan were prepared and executed shortly thereafter.

n4 The court stated, in part:

"The misrepresentations that have been found on the part of the [debtors] constitutes (sic) negligent misrepresentation and (sic) recognized as actionable fraud under California law (Civil Code § 1572(2)) which conduct the Court concludes justifies the remedy of rescission." Memorandum of Decision, p. 7.

The court entered its Judgment After Trial By Court on July 17, 1996. As of July 22, 1996, the Mayers obtained an Abstract Of Judgment reflecting an amount owed to them as of that date of \$ 411,079.56.

The Retirement Plan is reflected in two documents, the Phillips Retirement Plan and the Phillips Retirement Trust. In those documents, Debtors are [\*\*8] the participants, the sponsors, the administrators and the trustees of the Retirement Plan. Unlike the situations in numerous cases relied on by Debtors, there are no third parties who played any role in the implementation and operation of the Retirement Plan. Also, unlike the facts of those cases, no assets were used to fund the Retirement Plan other than assets of the Debtors, all of which presumably were subject to the claims of creditors (including the Mayers), subject only to proper exemptions available to Debtors.

On or about April 25, 1996, Debtors transferred the Residence n5 and marketable investments to the Retirement Plan. According to Schedules C and D, the Residence has a value of \$ 350,000 and is subject to a deed of trust in favor of Union Bank securing a debt of \$ 39,226. Of the Debtors' equity, \$ 75,000 is claimed as exempt as a homestead under California Code of Civil Procedure section 704.710, with the balance (\$ 216,481) claimed as exempt as a private retirement plan under Code of Civil Procedure section 704.115. The other assets in the Retirement Plan, characterized as being in

various mutual funds and related investments, have a value of \$ 74,308 as of the petition [\*\*9] date.

n5 The Grant Deed transferring the Residence from the Debtors, husband and wife, as joint tenants, to themselves as trustees of the Phillips Retirement Trust, dated April 24, 1996, conveys the Residence "reserving therefrom, however, the duly recorded homestead interest in said real property, as evidenced by recorded Phillips homestead declaration." Thus, Debtors attempted to reserve their homestead amount outside of the Retirement Plan, and to exempt the balance of the value of the Residence in the Retirement Plan.

The Residence is not a revenue or income producing asset as it is occupied by Debtors, who maintain it as their primary residence. [\*\*200] They do not pay any rent to themselves as trustees of the Retirement Plan although they do pay the mortgage payments on the Residence. Under the terms of the Retirement Plan, the assets therein are reachable upon Charles Phillips' 65th birthday, February 16, 1997.

According to Debtors, the purpose of the transfers of assets to the Retirement Plan was to have the [\*\*10] assets there and available. In their mind, transfer of substantial assets to the Retirement Plan seemed the prudent thing to do. In fact, Mrs. Phillips expressly conceded that funds were put into the Retirement Plan "to protect them" as they were in jeopardy.

Debtors filed their voluntary Chapter 13 petition on August 7, 1996.

As things stand today the Retirement Plan contains all but approximately \$ 25,000 of the Debtors' assets, the latter amount having been expressly withheld in anticipation of filing bankruptcy to deal with creditors in the Chapter 13 case. No additional contributions to the trust are likely n6 and the Debtors project selling the Residence in the year 2003, investing the net proceeds and living on the income produced by the investments in the Retirement Plan, together with whatever is available to them as social security benefits.

n6 In the Phillips Retirement Plan, Section 3.01. Sponsor Contributions, provides, in part, the "Sponsor shall make such contributions to Plan for the benefit of the Participants ... from time to time and in such amounts as the Sponsor shall determine." The Phillips Retirement Trust, in Article I.A. Establishment of Trust, provides, in

part, the "Sponsor shall make contributions in such manner and at such times as shall be appropriate."

Based upon the unequivocal testimony that there would be no further contributions to the Retirement Plan, these words found in the Retirement Plan are virtually meaningless and undermine any notion that the Retirement Plan is a true private retirement plan that has been declared exempt by the California Legislature.

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#### IV. Discussion

The critical question for the court to decide is whether the Retirement Plan constitutes a "private retirement plan" as provided in subparagraph (1) of California Code of Civil Procedure section 704.115(a) ("Section 704.115"), which section curiously and unhelpfully defines "private retirement plan" as a "Private retirement plan". There apparently is no legislative history to help the court determine whether Debtors may create such a plan entirely on their own.

Subparagraph (b) of Section 704.115 provides that:

All amounts held ... by a private retirement plan, for the payment of benefits as an annuity, pension, retirement allowance ... from a private retirement plan are exempt. (Emphasis added.)

If the Retirement Plan is a "private retirement plan" under Section 704.115, the next question is whether the Retirement Plan was "designed and used" for Debtors' retirement purposes. *Bloom v. Robinson (In re Bloom)*, 839 F.2d 1376 (9th Cir. 1988); *Daniel v. Security Pacific National Bank (In re Daniel)*, 771 F.2d 1352 (9th Cir. 1985); *Yaesu Electronics Corp. v. Tamura*, 28 Cal. App. 4th 8 (1994). If both questions are answered in the [\*\*12] affirmative, then all assets in the Retirement Plan are exempt. n7

n7 The Mayers have stipulated with Debtors that the amount in the Retirement Plan is not at issue. No actuarial evidence was submitted to determine if the value in the Retirement Plan is excessive. In other words, as a matter of law the amount is "reasonably necessary" for Debtors' retirement.

##### a. The 1977 and 1985 Activities.

Preliminarily, the court must determine whether the 1977 informal retirement plan and the Revocable Trust are of any legal significance. The court rejects both of those devices as irrelevant to the issues at hand. First, the informal retirement plan was nothing more than Debtors deciding that they wanted to keep their assets for themselves. There was no "plan" involved at all. At best, there was a recognition by two people that they wanted to keep their own assets, a rather normal reaction of almost anyone, particularly someone who did not then and do not now have children or other family members for whom they might [\*\*13] set up some sort of schedule for gifting excess assets [\*\*201] as they advance in years. Nor have Debtors presented any evidence of any philanthropic tendencies either in 1977, 1985 or 1996, any one of which might have established a pattern of recognizing that some assets might intentionally be rendered unavailable to them in their later years. In other words, the statement that Debtors intended to retain their assets for their retirement is tantamount to saying they intend to keep those assets from their creditors.

By 1985 some manifestations of Debtors' intent at least was reduced to writing, but the evidence is convincing that they created the Revocable Trust for estate planning purposes. They were very informal about how they dealt with assets included in the Revocable Trust. Even if by stretching the stated purposes as of 1985 (see footnote 3) to their litigation position in 1997 that this was an exempt private retirement plan, the Debtors did not treat the assets in that trust as part of any actual retirement plan. In any event, for many of the same reasons the Retirement Plan is not held to be a private retirement plan, the Revocable Trust fails as well.

##### b. The Self-Settled Trust [\*\*14] .

The Retirement Plan is a self-settled trust in that the Debtors as settlors or trustors are the beneficiaries. As such, unless exempt by Section 704.115, the assets in that Retirement Plan are just as vulnerable to the claims of Debtors' creditors, including the Mayers, as they were before they were transferred. *Nelson v. California Trust Co.*, 33 Cal. 2d 501, 502, 202 P.2d 1021 (1949); *Yaesu Electronics Corp. v. Tamura*, 28 Cal. App. 4th 8 (1994); *Brownell v. Kilian (In re Schneider's Estate)*, 140 Cal. App. 2d 710, 296 P.2d 45 (1956). The California Supreme Court in *Nelson* stated it most succinctly and most emphatically:

"It is against public policy to permit a man to tie up his property in such a way that he can enjoy it but prevent his creditors from reaching it." 33 Cal. 2d at 502 (1949).

The California Legislature confirmed the rule of Nelson in California Probate Code section 15304(a) which states, in part:

If the settlor is a beneficiary of a trust created by the settlor and the settlor's interest is subject to a provision restraining the voluntary or involuntary transfer of the settlor's interest, the restraint is invalid against transferees [\*\*15] or creditors of the settlor. n8

n8 Former Probate Code section 15304(a), added by 1986 Cal. Stat. Ch. 820, § 40 was repeated verbatim in 1990 enactment of the California Probate Code (Stats. 1990, c. 79 (A.B. 759), § 14, operative July 1, 1991. The Law Revision Commission Comment to that section cites Nelson with approval.

The Retirement Plan fits squarely within the reach of Probate Code section 15304(a), since the Phillips Retirement Plan contains a typical spendthrift provision. n9

n9 Section 15.02. Inalienability Of Benefits, provides in part:

"The right of any participant or beneficiary to any benefit or payment under the Plan shall not be subject to voluntary or involuntary transfer, alienation or assignment, and, to the fullest extent permitted by law, shall not be subject to attachment, execution, garnishment, sequestration or legal or equitable process."

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Debtors argue that the application of California Probate Code section 15304(a) to this case will destroy the exemptions of all individual tax-qualified plans such as "... IRA's and self-employed retirement plans (most of which are self-settled, self-administered and self-controlled)..." (emphasis added). (Debtors' Post Trial Memorandum, p. 3, 11. 23-25). Debtors' concern about self-employed retirement plans and the possible loss of protection under Section 704.115(a)(3) is misplaced. That subsection refers to "individual retirement annuities or accounts" and not to "self-employed retirement plans" as suggested.

Individual Retirement Accounts ("IRA's") must have banks or others as trustees (26 U.S.C. § 408(a)(2)) and thus the evils dealt with nearly fifty years ago in Nelson, and visited by the California Legislature in its 1991

amendments to the California Probate Code, are not present.

[\*202] IRA's quite obviously are created and controlled by the individuals who claim them as exempt, but the California Legislature has distinguished between IRA's in Section 704.115(a)(3), where there is a limitation (to the extent necessary to provide support, etc.) on the amount exempt under [\*\*17] Section 704.115(e) n10 and private retirement plans and Internal Revenue Code section 403b retirement plan annuities exempt under Section 704.115(a) or (b). n11 The Internal Revenue Code strictly limits how much (\$ 2,000) an individual may contribute in any taxable year (26 U.S.C. § 408(a)(1)). Creditors are thus protected by the amount of assets a debtor may shelter in an IRA each year, and protected again by how much can be exempted once those assets become subject to the claims of creditors. By permitting Debtors to claim as exempt tax sheltered trusts that they control, the California Legislature in no way intended debtors to transfer substantially all of their assets to such a trust in order to claim them as exempt.

n10 See *In re Vigghiany*, 74 Bankr. 61 (Bankr. S.D. Cal. 1987).

n11 See *In re MacIntyre*, 74 F.3d 186 (9th Cir. 1996).

Debtors also rely on numerous cases involving individuals who enjoy the benefits of section 704.115(a) via their own private retirement plans. But those cases all involve [\*\*18] third parties, even though in some cases those third parties are wholly-controlled professional corporations of the debtors. *In re Bloom, supra*, involved a corporate retirement plan created eight years prior to bankruptcy. The debtor was one of two owners of the medical corporation that created the plan. In *In re Macintyre, supra*, the debtors were two married physicians employed by a non-profit hospital that withheld from their paychecks contributions to an Internal Revenue Code § 403b retirement annuity. *In re Witwer*, 148 Bankr. 930, 939 (Bankr. C.D. Cal. 1992), concerned the debtor's own medical professional corporation as did *In re Cheng*, 943 F.2d 1114, 1116 (9th Cir. 1991). In *In re Crosby*, 162 Bankr. 276 (Bankr. C.D. Cal. 1993), the debtor claimed exempt her interest in a profit sharing plan established by her wholly-owned corporation, CAT Productions.

More importantly, none of the cases relied on by Debtors involves assets which, prior to the transfer into the Retirement Plan, were available to satisfy the claims of the debtor's creditors. Absent some indication that assets found in those various plans were ever available to

