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Retirement Plans and Creditor Protection

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I. [9.1] INTRODUCTION

This chapter discusses creditor protection for traditional retirement plans — that is, those governed under the Employee Retirement Income Security Act of 1974 (ERISA), 29 U.S.C. §1001, *et seq.*, and individual retirement accounts (IRAs). ERISA plans are those sponsored by employers and include defined benefit plans and defined contribution plans such as profit-sharing plans and 401(k) plans. This chapter does not address creditor protection issues in connection with nonqualified retirement plans such as deferred compensation plans and “rabbi” trusts. For convenience, unless the context denotes otherwise, this chapter refers to ERISA plans and IRAs as “retirement plans.”

When trying to determine whether a debtor’s retirement plan benefits are insulated from his or her creditor’s claims, there are different rules that apply depending on whether the claim arises from a spouse or a general creditor and whether the debtor has filed for protection under the bankruptcy laws. This chapter discusses those distinctions.

II. [9.2] APPLICABLE BANKRUPTCY LAWS

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), Pub.L. No. 109-8, 119 Stat. 23, was enacted April 20, 2005, and became effective October 17, 2005. While the primary focus of the BAPCPA was to make bankruptcy protection more difficult for debtors who had the capacity to pay, the BAPCPA increased, in some cases, the creditor protection available to retirement plans.

Before adoption of the Bankruptcy Abuse Prevention and Consumer Protection Act, the protection afforded retirement plans from creditors during bankruptcy had been subject to multiple rules depending on the type of retirement plan and the applicable state. Employer-sponsored retirement plans received complete protection under ERISA, but only a limited number of retirement plans were actually subject to ERISA. For non-ERISA retirement plans — for example, IRAs — protection varied by state. The extent of relief for bankrupt debtors with non-ERISA retirement plans depended on which protections applied for a particular debtor under the laws of the state in which the debtor resided. Protection varied from unlimited in some states to none in others, and practitioners often had difficulty keeping track of which states applied which protections.

The BAPCPA simplified the creditor protection rules for retirement plans by eliminating much of the differentiation among types of plans and bankruptcy jurisdictions. A brief summary of the basics of asset protection in bankruptcy is appropriate and is included in §§9.3 – 9.8 below before the specific application of the BAPCPA to retirement benefits is discussed in §§9.9 – 9.13.

III. [9.3] BASICS OF ASSET PROTECTION IN BANKRUPTCY

There are two ways that an asset can be protected from distribution among creditors of a debtor’s bankruptcy estate under the Bankruptcy Abuse Prevention and Consumer Protection Act. Assets can be either excluded or exempted. See §§9.4 – 9.6 below.

A. [9.4] Excluded Assets

A bankruptcy estate is considered to be “all legal or equitable interests of the debtor in property.” 11 U.S.C. §541(a)(1). However, if an asset is not considered a part of the bankruptcy estate in the first place, then it cannot be among the assets to be divided among the debtor’s creditors and it is, in effect, an excluded asset. *Id.* An ERISA plan is an example of an excluded asset.

B. Exempted Assets

1. [9.5] In General

In addition to excluded assets, as discussed in §9.4 above, the Bankruptcy Abuse Prevention and Consumer Protection Act also provides for exemptions for certain assets of a debtor, thereby making them unavailable to creditors and allowing them to remain the property of the debtor. 11 U.S.C. §522. When an asset meets the requirements for being exempted, even though it is property the debtor owns, the asset is removed from the bankruptcy estate. *Id.* The most common form of exemption is the homestead exemption, which exempts the individual’s residence or a portion thereof from the bankruptcy estate. 11 U.S.C. §522(d)(1).

2. [9.6] Types of Exemptions

There are actually two distinct sets of exemptions that may apply to a debtor under the Bankruptcy Abuse Prevention and Consumer Protection Act. The first are federal exemptions, and the second are state exemptions.

All states may use the federal exemptions. 11 U.S.C. §522(b). However, the states are also given the opportunity to “opt out” of the federal exemptions and instead design their own list of exemptions that will be applicable to debtors domiciled in their state. *Id.* Many states, in fact, have opted out and use their own exemptions instead. Once a state has opted out of the federal exemptions, a debtor who is a resident of that state must use that state’s exemptions. *Id.* Illinois is one of the states that has opted out. 735 ILCS 5/12-1201. Therefore, a bankrupt debtor who is a resident of Illinois must use the Illinois exemptions to remove assets from his or her bankruptcy estate. *Id.* It is unclear whether the more restrictive federal retirement plan exemption set forth under 11 U.S.C. §522(b)(3)(C) preempts Illinois’ exemption for retirement funds, which is unlimited. This is further discussed in §9.10 below.

IV. RETIREMENT PLANS AND THE BANKRUPTCY ESTATE

A. [9.7] ERISA Retirement Plans

ERISA is applicable to employer retirement plans, including all types of defined benefit plans, 401(k)s, 403(b)s, profit-sharing plans, and money purchase pension plans. ERISA states that retirement benefits under employer-sponsored retirement plans “may not be assigned or alienated.” 29 U.S.C. §1056(d)(1). This is important because, in defining what is or is not

included in the bankruptcy estate, federal law states that a “restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable nonbankruptcy law” is enforceable under the Bankruptcy Code, so the benefits are not part of the debtor’s bankruptcy estate. 11 U.S.C. §541(c)(2).

In 1992, the United States Supreme Court declared in *Patterson v. Shumate*, 504 U.S. 753, 119 L.Ed.2d 519, 112 S.Ct. 2242 (1992), that the ERISA “anti-alienation” rules do, in fact, constitute an enforceable non-bankruptcy law restriction on the transfer of a debtor’s assets held in trust, thereby causing employer plan assets subject to ERISA and an anti-alienation clause to be excluded from the debtor’s bankruptcy estate. In essence, the effect of ERISA, and the Supreme Court’s interpretation of it in *Patterson*, was to entirely protect ERISA-sponsored employer retirement plans by excluding a debtor’s benefits from consideration in bankruptcy.

It is important to note that this protection applied only to ERISA retirement plan assets. If a retirement plan was not subject to ERISA, it was not excluded from the bankruptcy estate. The most common plans not subject to ERISA and not receiving this protection are traditional IRAs, Roth IRAs, and SIMPLE (savings incentive match plan for employees) IRAs.

B. [9.8] IRAs

The states that opted out of the federal exemptions under the Bankruptcy Abuse Prevention and Consumer Protection Act, including Illinois, have included IRA accounts in their list of state exemptions, thereby providing partial or full creditor protection for IRAs. In states, however, that use the federal exemptions or grant creditors the right to choose federal instead of state exemptions, IRAs have historically been troublesome.

In the list of federal exemptions, it is provided that the right to receive a 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 is considered an exempt asset to the extent reasonably necessary for support of the debtor and his or her dependents. 11 U.S.C. §522(d)(10)(E). However, courts have differed in their interpretations of whether IRAs are eligible for exemption under these provisions. In *Rousey v. Jacoway*, 544 U.S. 320, 161 L.Ed.2d 563, 125 S.Ct. 1561, 1568 (2005), the U.S. Supreme Court resolved differences of interpretation in the lower courts by definitively confirming that IRAs are “similar plan[s].” Consequently, the court ruled that IRAs should be protected from creditors, subject to the limitation that they would be exempted only to the extent reasonably necessary for the support of the debtor and his or her dependents. *Id.*

V. APPLICATION OF THE BAPCPA TO RETIREMENT PLANS

A. [9.9] In General

Under the Bankruptcy Abuse Prevention and Consumer Protection Act, virtually all types of retirement plans are now exempt assets under the federal exemptions in bankruptcy proceedings. This was accomplished by adding a provision creating a new exemption for “retirement funds” to the extent that those funds are in a fund or account that is exempted from taxation under §401,

§403, §408, §408A, §414, §457, or §501(a) of the Internal Revenue Code. 11 U.S.C. §§522(b)(3)(C), 522(d)(12). These include funds under 401(k), 403(b), profit-sharing, money purchase, and defined benefit pension plans, as well as IRAs, including SEPs and SIMPLE retirement plans. However, nonqualified annuities, although tax deferred and ostensibly for retirement, are not protected under these provisions since the applicable section (§72) is not listed. As mentioned in §9.6 above, these provisions exempting retirement plans could apply regardless of whether the debtor is eligible or required to use the federal or state exemptions. 11 U.S.C. §522(b)(3)(C).

B. [9.10] IRA Caution

Unfortunately, although the Bankruptcy Abuse Prevention and Consumer Protection Act has included an exemption for most retirement plans, the exemptions for those plans is not unlimited. In the case of a Roth or traditional IRA, the maximum amount of the exemption is limited to \$1,095,000, as adjusted for inflation April 1, 2007. 11 U.S.C. §522(n). Almost all of the types of employer-sponsored retirement plans, such as 401(k)s and 403(b)s, are not subject to the \$1,095,000 limitation. Practically speaking, this \$1,095,000 exemption will cover most non-rollover IRAs because of the minimal amount of money that can be contributed to them.

In addition, any amount held in an IRA that is attributable to eligible rollover contributions from an ERISA or other employer-sponsored retirement plan will not be subject to the \$1,095,000 limitation. *Id.* However, rollovers from one IRA to another IRA will be subject to the \$1,095,000 limitation. While a SEP or SIMPLE IRA is not subject to the \$1,095,000 limitation, rollovers from a SEP or SIMPLE to a traditional IRA will subject the new traditional IRA to the \$1,095,000 limitation. *Id.*

The BAPCPA's changes also allow for the courts to increase the \$1,095,000 IRA exemption limit in cases in which it is in the "interests of justice" to do so. *Id.* It remains for the courts to actually apply this provision to show what might actually constitute such a need.

An issue that exists for bankrupt debtors who reside in an opt-out state such as Illinois is whether the \$1,095,000 limitation applies to IRAs. An argument can be made that the limitation does not apply because 11 U.S.C. §522(b)(3)(A) (permitting state exemptions) is available to debtors notwithstanding the \$1,095,000 limitation. It is just as arguable, however, that the \$1,095,000 limitation is applicable to IRAs of debtors of opt-out states because any other interpretation would effectively render the limitation meaningless for debtors opting for state exemptions. The BAPCPA does not specifically address, however, whether IRAs exempted under §522(b)(3)(A) are meant to be subject to the \$1,095,000 limitation. Unfortunately, the legislative history also does not provide direction.

C. [9.11] Inherited IRA Caution

Based on a recent bankruptcy court decision, it would appear that an inherited IRA is not exempt under the federal bankruptcy exemptions. In *In re Jarboe*, 365 B.R. 717 (Bankr. S.D.Tex. 2007), a mother died leaving her IRA to her son. Several years later, the son filed for bankruptcy and claimed that the IRA was exempt under Tex.Prop. Code Ann. §42.0021. The bankruptcy

trustee, however, asserted that the inherited IRA was not exempt. The Bankruptcy Court agreed with the bankruptcy trustee.

The trustee conceded that if the mother were the bankrupt debtor, §42.0021 would exempt the IRA. However, in this case, the debtor obtained his interest upon his mother's death, which meant the son's interest was in an "inherited" IRA. The court recognized that no case in the U.S. Court of Appeals, Fifth Circuit, had addressed the exempt status of an inherited IRA, but it followed the reasoning of the bankruptcy courts from other circuits, which denied inherited IRAs exempt status. The basis of the distinction was that inherited IRAs were not funded by the debtor, and thus the policies behind exempting these accounts do not apply.

D. [9.12] Practice Pointers

The following basic rules should be remembered when attempting to exempt retirement plans from creditors by using federal exemptions approved by the Bankruptcy Abuse Prevention and Consumer Protection Act:

1. Traditional and Roth IRAs are exempt up to \$1,095,000.
2. SEP and SIMPLE IRAs are exempt for an unlimited amount.
3. All other types of ERISA or other employer-sponsored retirement accounts, or rollovers from them to IRAs, are exempt for an unlimited amount.
4. Although rollovers from qualified retirement plans into IRAs are exempt, rollovers from SEP or SIMPLE IRAs are not. Therefore, you should be cautious about consolidating SEP or SIMPLE IRAs into regular rollover IRAs if the balances exceed \$1,095,000 and the client is concerned about creditor protection.
5. Clients should keep records that document rollovers from ERISA or other employer retirement plans to ensure the ability to track which IRA accounts are eligible for unlimited protection.
6. If a debtor has a choice between federal and state exemptions and the state in which the debtor is a resident has no exemption limitation, he or she may find it preferable to choose that state's exemption.

E. [9.13] Remaining Issues

The following additional questions need to be addressed under the Bankruptcy Abuse Prevention and Consumer Protection Act:

1. If an IRA with protected "rollover contributions" from a qualified retirement plan is itself rolled over into another IRA, does the previous protected rollover treatment persist even though an IRA-to-IRA rollover yields no protection?

2. If an owner of an IRA with protected rollover contributions dies and his or her spouse elects to roll over the account to a new account in his or her name, does the protected rollover treatment persist?
3. What situations might constitute a reason to exceed the \$1,095,000 limitation in the interests of justice?
4. If an IRA is rolled over into a qualified employer retirement plan and subsequently is rolled back into an IRA, is the original IRA balance subject to \$1,095,000 risk, or is it laundered clean by passing through the employer retirement plan?
5. Is an IRA of a debtor of an opt-out state subject to the \$1,095,000 exemption limitation?

VI. [9.14] RETIREMENT PLANS AND THE ILLINOIS DEBTOR

Since Illinois is an opt-out state for purposes of the Bankruptcy Abuse Prevention and Consumer Protection Act, its exemptions apply to a bankruptcy estate and not those under the BAPCPA. 735 ILCS 5/12-1201. The same exemptions also apply to a debtor in a non-bankruptcy context.

Accordingly, under 735 ILCS 5/12-1006, the Illinois exemption statute for retirement plans, retirement plans are exempt from creditors' claims. A "retirement plan" includes an individual retirement account or a stock bonus, pension, profit-sharing, annuity, or similar plan or arrangement, including SEPs and SIMPLEs. *Id.* Moreover, in *Auto Owners Insurance v. Berkshire*, 225 Ill.App.3d 695, 588 N.E.2d 1230, 167 Ill.Dec. 1100 (2d Dist. 1992), the Second District held that funds representing proceeds of retirement plans do not lose their exempt character as a retirement plan when the debtor deposits them into his or her checking account at a savings and loan association. The court held that as long as the debtor continues to hold and use those funds for support of the debtor and his or her family, the exemption statute requires exemption of the funds traceable from exempt payments. However, if the debtor transforms support payments into an investment, the purpose of the statute is not being met and the funds not being used for support lose their exempt character. Accordingly, under Illinois law, exempt funds remain exempt as long as they retain the "quality of moneys" and are not used for other than support obligations of the debtor and his or her family. 588 N.E.2d at 1233, quoting *Philpott v. Essex County Welfare Board*, 409 U.S. 413, 34 L.Ed.2d 608, 93 S.Ct. 590, 592 (1973).

VII. SPOUSE'S RIGHTS UNDER RETIREMENT PLANS

A. [9.15] In General

In 1984, Congress enacted the Retirement Equity Act of 1984 (REA), Pub.L. No. 98-397, 98 Stat. 1426, which amended various provisions of ERISA. One of the major reasons for passing REA was to better protect spouses' survivor benefits under ERISA retirement plans. *Boggs v. Boggs*, 520 U.S. 833, 138 L.Ed.2d 45, 117 S.Ct. 1754, 1761 (1997). REA provides such

protection by requiring ERISA-governed retirement plans to automatically provide spouses certain survivor benefits upon the death of the plan participant. 29 U.S.C. §§1055(a), 1055(b)(1)(C)(i). However, the survivor benefits required by REA are only default provisions and may be waived by the plan participant's spouse. 29 U.S.C. §1055(c)(2). REA protection does not extend to non-ERISA type plans such as IRAs or other individual account plans.

B. [9.16] Waiver of Benefits

For a spouse to waive his or her benefits in an ERISA-governed plan, certain requirements must be strictly satisfied. Specifically, the waiver of survivor benefits must be in writing and signed by the waiving spouse with the waiving spouse's signature either notarized or witnessed by the retirement plan representative. 29 U.S.C. §1055(c)(2)(A). In addition, the substance of the waiver must

1. designate the beneficiary or beneficiaries entitled to survivor benefits in place of the spouse;
2. indicate whether the beneficiary designation or form of benefit may be changed by the participant spouse without the waiving spouse's further consent; and
3. acknowledge the effects of the waiver. *Id.*

C. [9.17] Rights of Prospective Spouses

An issue arises as to whether a prospective spouse can waive benefits under an ERISA-governed retirement plan. If yes, this begs the question whether a spouse's waiver of such benefits in a premarital agreement is effective.

The Illinois appellate court in *In re Estate of Hopkins*, 214 Ill.App.3d 427, 574 N.E.2d 230, 158 Ill.Dec. 436 (2d Dist. 1991), held that a prospective spouse can waive his or her right to survivor benefits under an ERISA-governed retirement plan without adhering to the specific waiver requirements of ERISA. However, the court acknowledged that compliance with the ERISA waiver provision is a matter of federal law. Generally, it is considered that a premarital waiver of survivor benefits is not effective and the waiver must actually be executed after the marriage of the parties in conformity with ERISA requirements.

D. [9.18] Determining Compliance with ERISA Waiver Requirements: Strict Compliance vs. Substantial Compliance

The federal circuit courts, including the Seventh Circuit, employ two doctrines to determine whether there has been compliance with the ERISA waiver requirements. One is the strict compliance doctrine and the second is the substantial compliance doctrine.

The strict compliance doctrine requires the court to use a term's or provision's ordinary meaning when interpreting a statute in which that term or provision appears. In contrast, the substantial compliance doctrine allows the court to construe the meaning of the term or provision

under review in a way that fulfills the statute's premise. The federal circuit courts have consistently held that the strict compliance doctrine must be applied when dealing with terms or provisions contained within ERISA. *See, e.g., Butler v. Encyclopedia Britannica, Inc.*, 41 F.3d 285, 294 (7th Cir. 1994); *Lasche v. George W. Lasche Basic Profit Sharing Plan*, 111 F.3d 863 (11th Cir. 1997). The only exception to this requirement occurs when a term's or provision's ordinary meaning would lead to an absurd result. *Commissioner v. Brown*, 380 U.S. 563, 14 L.Ed.2d 75, 85 S.Ct. 1162 (1965).

Even though the court in *In re Estate of Hopkins*, 214 Ill.App.3d 427, 574 N.E.2d 230, 235, 158 Ill.Dec. 436 (2d Dist. 1991), did not expressly declare that it was applying the substantial compliance doctrine in arriving at its decision, a reasonable conclusion is that it did because it provided that "a surviving spouse can waive her interests in a plan under REA without following its specific waiver requirements." Furthermore, the court disregarded the fact that the waiver under review neither named the beneficiary to take the place of the waiving prospective spouse nor acknowledged the effects of the waiver, which are two of its specific requirements dictated under ERISA. 29 U.S.C. §1055(c).

In reaching its decision, the appellate court in *Hopkins* relied on the Seventh Circuit's holding in *Fox Valley & Vicinity Construction Workers Pension Fund v. Brown*, 897 F.2d 275 (7th Cir. 1990), in which the court applied the substantial compliance doctrine in dealing with an ERISA waiver. However, reliance on *Fox Valley* is arguably misplaced because the Seventh Circuit dealt with the waiver made in a postnuptial agreement executed by a person already a spouse in contemplation of divorce, not a waiver made in a premarital agreement by a prospective spouse in contemplation of marriage. 897 F.2d at 278. The court in *Fox Valley* found the waiver valid because the person seeking to have the waiver set aside was no longer a spouse and as a result could no longer seek the protections afforded under REA as REA was enacted to protect spouses, not former spouses. 897 F.2d at 281. Accordingly, since the *Hopkins* court failed to properly apply either the strict compliance doctrine or federal case precedent in *Fox Valley*, it would be unwise for a practitioner to rely on *Hopkins* while drafting a waiver as part of a premarital agreement.

E. [9.19] Who Is a Spouse?

The Seventh Circuit has yet to rule on whether the substantial compliance doctrine can be used to interpret the term "spouse" as used in ERISA so that a prospective spouse is included in its meaning. If given the opportunity, it is unlikely that it would do so, as it has already required strict compliance with other unambiguous ERISA waiver provisions, including some of the very provisions that were lacking in the waiver in *In re Estate of Hopkins*, 214 Ill.App.3d 427, 574 N.E.2d 230, 158 Ill.Dec. 436 (2d Dist. 1991).

The Fourth Circuit has directly addressed the issue and applied the strict compliance doctrine to declare that waivers in a premarital agreement are ineffective because the prospective spouse does not fit within the ordinary definition of a "spouse." *Hagwood v. Newton*, 282 F.3d 285, 290 – 291 (4th Cir. 2002). It is likely that Illinois federal district courts will follow federal court precedent rather than the Illinois appellate court decision in *Hopkins* and render the waiver ineffective.

PRACTICE POINTER

- ✓ All is not lost for a practitioner seeking to disinherit a client's spouse of the client's retirement benefits. The practitioner can likely avoid the issue entirely by including a provision in the premarital agreement in which the client's prospective spouse promises to execute the necessary documentation to waive any right to survivor benefits in the client's ERISA-governed retirement plan by executing an ERISA waiver immediately after the marriage ceremony. *Lasche v. George W. Lasche Basic Profit Sharing Plan*, 111 F.3d 863 (11th Cir. 1997).
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F. [9.20] Acknowledgement of Waiver

Even though an individual as a participant in a retirement plan has taken the appropriate steps to ensure that the waiver is executed at the appropriate time, that is, after the marriage, there is still a possibility the waiver will be ineffective. According to 29 U.S.C. §1055(c)(2)(A)(iii), for a waiver to be effective, it must acknowledge the effects of the waiver. In *Pedro Enterprises, Inc. v. Perdue*, 998 F.2d 491 (7th Cir. 1993), the Seventh Circuit held that the waiving party cannot acknowledge the effects of the waiver for a pension plan not yet in existence. The court noted that it "is self-evident that a waiver [of survivor benefits in an ERISA-governed pension plan] cannot be knowing and considered if the thing to be relinquished has not yet been conceived of by the employer." 998 F.2d at 494. Accordingly, in a premarital agreement, a client's prospective spouse can generally waive acquired rights in property not yet acquired by the client (750 ILCS 10/4(a)(1)); however, a prospective spouse cannot waive the right to survivor benefits under ERISA-governed retirement plans.

In the absence of an effective ERISA waiver after one year of marriage, a new spouse acquires an interest in his or her spouse's ERISA-governed plan. Not so with an IRA. The magnitude of the new spouse's rights vary under state law. In some states, the new spouse's rights are only to share in prospective benefits, while in other states those rights might relate back to the entire plan proceeds.

PRACTICE POINTER

- ✓ A client contemplating marriage who is in a position to do so might consider rolling over his or her ERISA plan proceeds into an IRA prior to the marriage so as to preclude the future spouse from obtaining any rights to the plan proceeds.
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G. [9.21] Child Support, Alimony, and Attorneys' Fees

Although all ERISA-type plans contain spendthrift provisions that are designed to prevent creditors from attaching the debtor's retirement funds (29 U.S.C. §1056(d)(1)), the courts have permitted certain inroads. In *In re Marriage of Thomas*, 339 Ill.App.3d 214, 789 N.E.2d 827, 831, 273 Ill.Dec. 568 (2d Dist. 2003), the Second District held that ERISA and 735 ILCS 5/12-1006

permit a trial court's entry of a qualified domestic relations order (QDRO) to assign pension and other retirement benefits to a former spouse to satisfy a judgment for past-due maintenance and child support payments. The Illinois courts will also permit attorneys' fees to be awarded to the ex-spouse for his or her efforts. Some states permit inroads only for child support, while others do not permit the awarding of attorneys' fees.

VIII. [9.22] CONCLUSION

Counseling a client who is the owner of a retirement plan on how to avoid the claims of a debtor claimant can be a very difficult endeavor. Fortunately, for those seeking bankruptcy protection, the Bankruptcy Abuse Prevention and Consumer Protection Act provides a very clear map.

In the family law setting, it is possible to prevent a spouse-to-be from obtaining rights to the prospective spouse's ERISA-governed retirement plan. IRAs do not afford the prospective spouse rights.

Enforcement of past-due child support or alimony claims is governed by state law. States vary as to how far they will permit ex-spouses to reach retirement plans.

Generally, ordinary creditors are totally precluded from attaching ERISA-governed plans as well as IRAs in Illinois and many other states. Illinois goes further than many states and protects distributions from retirement plans as long as they are used for support and not investment.