Kearney Construction Company v. Travelers

Did you know you may have unintentionally pledged your individual retirement account ("**IRA**") as collateral for a loan just by signing up for a credit card or a car loan? Historically, when an individual signs a general pledge of "all assets," a creditor can only recover those assets specifically pledged to the creditor in the security agreement. It has been standard practice for any asset which is exempt under §222 of the Florida Statutes to remain exempt from the reach of creditors, because the exempt asset is not specifically pledged. Long standing public policy of the Florida legislature promotes the financial independence of the retired and elderly by protecting their IRAs and pensions plans with an exemption, thus reducing the need for public financial assistance. This consumer protection built into the framework of our existing law protecting Floridians from overreaching creditors, unfair transactions, and retirement poverty was recently cast aside in the decision of *Kearney Constr. Co., LLC v. Travelers Cas. & Sur. Co. of Am.*, 2019 WL 5957361 at *3 (11th Cir. 2019). The *Kearney* result flies in the face of the intent of the Florida legislature and the current statutory framework which requires a Florida Consumer to understand and acknowledge any waiver of a statutory exemption under Florida law.

The Eleventh Circuit, in the *Kearney* decision, without citing any Florida case law supporting its conclusion:

- blind-sides millions of Florida Consumers by rendering moot numerous statutory exemptions from creditors under Florida law for anyone who has signed a contract containing a broadly worded security interest provision;

- refashions the bankruptcy process into "winner takes all" for creditors which will further devastate Florida Consumers and businesses already reeling from the financial impact of the Coronavirus;

- creates a toxic environment for business because all business loans requiring a general pledge of assets would force business owners to give their creditors total access to their retirement savings, children's college funds, life insurance cash surrender values and coin collections as collateral;

- potentially triggers a ruinous immediate financial result for Consumers by causing the loss of the pledged amount of a Consumer's IRAs and qualified retirement plans, plus up to 40% of the full value to taxes and penalties upon making a general pledge of assets.

- causes citizens to unintentionally remove the exempt protection they have from their IRAs and qualified retirement plans which may cause them to become so destitute they must become wards of the state

In light of the serious issues resulting from the Kearney holding, Chapter 222 requires a legislative fix. In the absence of legislative action, a Consumer, by signing a document containing a blanket security interest provision, unknowingly places their IRA, pension plan, annuity, life insurance contract, or personal property at risk of forfeiture and confiscatory taxation.

A. Procedural History and Timeline of Events

On October 27, 2011, the United States District Court Middle District of Florida, Tampa Division granted a motion for entry of final judgment in favor of Travelers and against Kearney and others in the amount of $3,750,000. Magistrate Judge's Report and Recommendation, Docket 711, at 1-2. On March 1, 2012, Kearney executed a Revolving Line of Credit Promissory Note (the "**Promissory Note**") in favor of Moose Investments of Tampa, LLC ("**Moose Investments**"),. Magistrate Judge's Report and Recommendation, Docket 865, at 9. The Promissory Note was collateralized by a security agreement (the "**Security Agreement**") in which Kearney pledged a security interest in

> **all assets and rights of the Pledgor**, wherever located, whether now owned or hereafter acquired or arising, and all proceeds and products thereof, all good (including inventory, equipment and any accessories thereto), instruments (including promissory notes), documents, accounts, chattel paper, deposit accounts, letters of credit, rights, securities and all other investment property, supporting obligation, any contract or contract rights or rights to the payment of money, insurance claims, and proceeds, and general intangibles (the "Collateral"). *Id.* at 9-10 (emphasis added).

On October 25, 2012, Kearney deposited $448,646.03 into an IRA at USAmeriBank. *Id.* at 10. These funds consisted of rolled-over funds from Kearney's previously existing IRA at USAmeriBank and funds deposited as rollover contribution from an IRA at a different bank. *Id.* On October 27, 2014, Kearney requested the funds from the IRA be transferred into a money market account to be held as tenants by the entirety with his wife, and such funds were transferred into a money market account. *Id.* Two days later, Kearney attempted to reestablish an IRA in his individual name. *Id.* On November 12, 2014, USAmeriBank received the garnishment of the account and the funds were placed on hold. *Id.* at 12-13. On January 2, 2015, USAmeriBank deposited the funds into a new IRA. *Id.* at 14.

On July 23, 2015, the Magistrate Judge granted Travelers' motion for a writ of garnishment directed to USAmeriBank. Magistrate Judge's Report and Recommendation, Docket 711, at 2.

B. District Court Decisions and Magistrate Judge's Reports and Recommendations

Magistrate Judge McCoun III submitted a Report and Recommendation on March 17, 2016 (Docket 711) and a Report and Recommendation on August 16, 2017 (Docket 865) addressing the numerous summary judgment motions related to the writ of garnishment directed to USAmeriBank. The United States District Court Middle District of Florida, Tampa Division then adopted, confirmed, and approved in all respects the Reports and Recommendations submitted by Magistrate Judge McCoun III in Docket 711 and Docket 865. *Kearney Construction Company, LLC v. Travelers Casualty & Surety Company of America*, 2016 WL 1394372 at *1; *Kearney Construction Company, LLC v. Travelers Casualty & Surety Company of America*, 2017 WL 4244390 at *1.

1. Magistrate Judge's Report and Recommendation – Docket 865

In his Report and Recommendation submitted on August 16, 2017, Magistrate Judge McCoun III issued a recommendation on three summary judgment motions related to Kearney's IRA held by USAmeriBank and subject to a writ of garnishment. Magistrate Judge's Report and Recommendation, Docket 865, at 1. The applicable summary judgment motions involved determining whether the funds were properly rolled over to an IRA within the 60-day period required by § 408 of the Code or qualified for the waiver under § 408, and whether the funds rolled over into Kearney's IRA lost the exempt status because of the pledge of collateral in Kearney's security agreement with Moose Investments. *Id.* at 7.

Kearney argued the funds held in his IRA were exempt from garnishment under Fla. Stat. § 221.21(2). *Id.* at 8. Florida Statutes § 221.21(2) permits an account to be exempt from creditor claims if such account is maintained in accordance with a plan deemed exempt under § 408 of the Code. *Id.* at 15. As discussed in the Report and Recommendation, the purpose of Fla. Stat. § 221.21(2) was to "confer on retirement plans a broad exemption from the claim of creditors" and because the Florida legislature "made the policy decision that it should protect the assets of IRA's and pension plans." *Id.* at 17-18 (citing *Dunn v. Doskocz*, 590 So. 2d 521, 522, n.2 (Fla. Dist. Ct. App. 1991)).

Kearney claimed he complied with the laws regarding rolling over IRA funds in an exempt IRA, and any failure to comply with the 60-day period for rolling over the funds was outside of his control and did not invalidate the exempt status of the funds. *Id.* at 8. With respect to the issue of whether the funds were properly rolled over into an IRA within the appropriate 60- day period, the Magistrate Judge found genuine issues of material fact precluding summary judgment in favor of Travelers. *Id.* at 18. As discussed in the Procedural History and the Timeline of Events section, Kearney initially directed USAmeriBank to withdraw the IRA funds to establish a money market account. *Id.* at 19. However, Kearney immediately attempted to re-establish an IRA using those funds. *Id.* Although USAmeriBank representatives made representations the funds would be transferred within the rollover period, the funds were not transferred in that time frame. *Id.* It was unclear whether the rollover qualified for a waiver of such deadline or that the account was otherwise in substantial compliance with § 408. *Id.* at 19. One should note Florida law has consistently held a transfer of an asset exempt from creditors to another asset exempt from creditors is not a fraudulent transfer, nor is the asset reachable by such creditors. Thus, even if the perplexing transfer from the IRA to Tenants by the Entirety had been successful, such account would still be exempt under Florida law. Since the exemption statutes in Florida are liberally construed in favor of a debtor, the Magistrate Judge concluded

> "facts surrounding the late transfer of the funds are in need of further development to determine whether such substantial compliance was met. As such, on this record and as to this issue, I cannot definitely say that Mr. Kearney is not entitled to the benefit of the retirement exemption under Florida Statute § 221.21(2)(a)." *Id.* at 20.

Travelers argued Kearney pledged the IRA as security to Moose Investments pursuant to the Promissory Note and Security Agreement, and such pledge of the IRA as collateral caused the funds in the IRA to both lose its tax-exempt status and its exempt status from garnishment. *Id.* at

8-9. Kearney responded he did not pledge or intend to pledge the IRA to Moose Investments, and asserted the Promissory Note and Security Agreement contained latent ambiguity with respect to whether the IRA was included as part of the collateral. *Id.* at 9. Specifically, Kearney argued the Promissory Note and Security Agreement did not specify the IRA was intended to be pledged as a "deposit account" as part of the collateral. *Id.* at 22- 23.

The Magistrate Judge referenced § 408(e)(4) of the Code, which provides "[i]f, during any taxable year of the individual for whose benefit an individual retirement account is established, that individual uses the account or any portion thereof as security for a loan, the portion so used is treated as distributed to that individual." *Id.* The Magistrate Judge then cited a Fifth Circuit case, which determined pledging IRA funds as security for a loan has the same effect as withdrawing such funds from the IRA and investing them in non-IRA CDs. *Id.* (citing *Lewis v. Bank of Am.*, 343 F.3d 540, 545 (5th Cir. 2003). It should be noted neither party cited any Florida case law specifically on the issue of pledging a retirement account as collateral. *Id.* at 22, n.9. The Magistrate Judge cited cases from the United States Bankruptcy Court for the Southern District of Ohio and the Eastern District Court of Virginia to support the conclusion that a pledge of IRA funds causes such funds to lose their creditor exempt status. *Id.* at 21-22 (citing *In re Roberts*, 326 B.R. 424, 426 (Bankr. S.D. Ohio 2004), and *XL Specialty Ins. Co. v. Truland*, 2015 WL 2195181, at *11–13 (E.D. Va., May 11, 2015)). However, those cases were not decided under Florida law, are not binding on a Florida court, and rest in jurisdictions that do not necessarily have state law creditor exemptions similar to Florida for IRA's.

The Magistrate Judge stated Kearney pledged all of his assets and rights in the Security Agreement securing the Promissory Note. *Id.* at 22. Further, the Magistrate determined the language of the Security Agreement was "clear, unambiguous, and without exception." *Id.* at 26. Furthermore, the broad language of the Security Agreement "encompassed potential retirement accounts or funds, such as the [IRA] at issue here." *Id.* at 28. As a result, the Magistrate Judge concluded the funds held in Kearney's IRA lost their tax-exempt status and were not protected by Fla. Stat. § 221.21(2) or any other statutory exemption. *Id.* at 29.

C. United States Court of Appeals for the Eleventh Circuit Decision

The Eleventh Circuit resolved two issues on appeal with respect to the status of Kearney's USAmeriBank accounts. *Kearney Constr. Co., LLC v. Travelers Cas. & Sur. Co. of Am.*, 2019 WL 5957361 at *1 (11th Cir. 2019). The first issue involved whether Kearney pledged his IRA as collateral under the Security Agreement with Moose Investments. *Id.* The Eleventh Circuit agreed with the United States District Court Middle District of Florida, Tampa Division, and determined the language in the Security Agreement "constitutes an unambiguous pledge of 'all assets and rights of the Pledgor,' including his IRA Account . . . ." *Id.* at *2. Kearney provided his own affidavit and the affidavit of the manager of Moose Investments as evidence Kearney did not intend to include the IRA as part of the collateral. *Id.* Like the Magistrate Judge and the District Court, the Eleventh Circuit was unconvinced and considered Kearney's affidavit to be "a sham" and "self-serving, conclusory, and contradicted by other evidence in the record." *Id.* Without citing any other authority, the Eleventh Circuit concluded the District Court properly held the IRA was pledged as security for his loan with Moose Investments and "therefore was not exempt under § 222.21." *Id.* at *3.

As discussed in Footnote 7, the Eleventh Circuit rejected Kearney's argument that "even if [the Court] hold[s] that the IRA account was pledged, [Kearney] nevertheless is protected by Fla. Stat. §§ 222.21(2)(a) 1 and 2 because it has never been determined that his IRA does not qualify as exempt from taxation." *Id.* at *2, n.7. The Eleventh Circuit stated "Fla. Stat. §§ 222.21(2)(a)(1) and (2) provide that when an IRA plan has been preapproved or determined to be exempt by the Internal Revenue Service, then, if the plan is maintained in accordance with its governing instrument, it is exempt from creditors' claims, unless the plan has subsequently been determined not to be exempt from taxation." *Id.* The Eleventh Circuit asserted Fla. Stat. § 222.21(2)(a)(1) can be applied only if the IRS "pre- approved" the IRA as exempt from taxation. *Id.* Furthermore, the Eleventh Circuit also stated Fla. Stat. § 222.21(2)(a)(2) can be applied only if the IRS has "determined" an IRA is exempt from taxation. *Id.* The Eleventh Circuit concluded Kearney provided no evidence the IRS "pre-approved" Kearney's IRA as exempt from taxation, or the IRS made a "determination" Kearney's IRA was exempt from taxation. *Id.* Since Kearney had the burden of proving such "pre-approval" or "determination," Kearney could not avail himself of the creditor exemption. *Id.* Candidly, every attorney is well aware IRA's are not individually pre-approved, nor does an IRA ever seek determination of tax-exempt status from the IRS. Thus, the conclusion of the Eleventh Circuit on this issue rests somewhere between ill-informed and completely clueless.

D. Outstanding Issues Resulting From the *Kearney* Holding

1. Blind-sides millions of Florida Consumers: Debtors, creditors, and their attorneys have long operated under the belief any asset which is exempt under § 222 of the Florida Statutes is exempt from the reach of creditors unless such asset is specifically pledged in a secured transaction. This widely held belief was cast aside by the Eleventh Circuit in *Kearney*. Although, the Security Agreement at issue in *Kearney* never mentioned Kearney's IRA specifically as part of the collateral, the Eleventh Circuit dismissed the creditor exempt status of the IRA which is otherwise protected under § 222 of the Florida Statutes. The broad language of *Kearney* suggests no exemption is effective in the face of a grant of a blanket "form" security interest.

2. Refashions Bankruptcy into "Winner Takes All": The financial impact resulting from the 2020 coronavirus pandemic is incalculable at this juncture. At a minimum, it is a near certainty there will be a precipitous rise in the number of Florida Consumers forced to declare bankruptcy. Under the United States Bankruptcy Code (the "**Bankruptcy Code**"), a bankruptcy trustee, for purposes of marshaling assets, is permitted to step into the shoes of any actual or theoretical creditor of the debtor. Pursuant to Section 544(b) of the Bankruptcy Code, a bankruptcy trustee "may avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable under applicable law by a creditor holding an unsecured claim" allowable under Section 502 or not allowable under Section 502(e) of the Bankruptcy Code. In other words, a bankruptcy trustee can file claims against the debtor that any creditor may have, even if such creditor's claims are based on non-bankruptcy law. If the expansive holding in *Kearney* stands, the bankruptcy trustee can assert all of the rights under the general pledge found in *Kearney*. This will not only give the actual creditor access to the funds in the IRA up to the amount of its claim, but also to the entire amount of the IRA in excess of the actual creditor's claim.

There is no public policy reason for allowing a bankruptcy trustee to seize a Consumer's otherwise exempt assets because of the "gotcha" holding in *Kearney*. The holding in *Kearney* spurns the intent of the Florida legislature to protect certain assets, such as IRA's and pension plans, from creditors. *See Dunn v. Doskocz*, 590 So. 2d 521, 522, n.2 (Fla. Dist. Ct. App. 1991) ("It appears the legislature has made the policy decision that it should protect the assets of IRA's and pension plans, thereby promoting the financial independence of IRA and pension plan beneficiaries in their retirement years—in turn reducing the incidence and amount of requests for public financial assistance").

Under Fla. Stat. § 77.01, a creditor can step into the shoes of a debtor and collect proceeds from a third party garnishee holding money due or property owned by the debtor through a writ of garnishment. Additionally, since Florida is an "opt-out" state under the Bankruptcy Code, Florida's exemptions (rather than the much more limited federal exemptions) are available to Florida Consumers filing for bankruptcy. Under the United States Bankruptcy Code (the "**Bankruptcy Code**"), a bankruptcy trustee, for purposes of marshaling assets, is permitted to step into the shoes of any actual or theoretical creditor of the debtor. Florida Statutes Chapter 222 contains most of the statutory exemptions from creditors under Florida law. Specifically, Fla. Stat. § 222.21(2)(a) allows Florida Consumers to claim an exemption from creditors for funds held in IRA's and other tax-exempt accounts. Practitioners (and banks) have long deemed funds held in an IRA are protected from garnishment under Fla. Stat. § 222.21(2)(a) as long as the plan is maintained in accordance with the applicable provisions of the Code. In *Kearney*, the Eleventh Circuit held a Consumer could utilize the exemptions under Fla. Stat. §§ 222.21(2)(a)(1) and (2) only if the Consumer could prove the IRS either "pre-approved" the IRA as exempt from taxation or made a "determination" the IRA was exempt from taxation. In reality, IRA's are not individually pre-approved and the custodians of such IRA's never seek determination of tax-exempt status from the IRS. Furthermore, it is both absurd and impossible to require IRA holders to obtain the IRS's approval regarding the status of their IRA's as exempt to avail themselves of the protections afforded to them under Florida law. The *Kearney* decision creates a dangerous precedent by permitting funds held in an IRA or other retirement account to be garnished by creditors without a Consumer making an express and knowing waiver of the Fla. Stat. § 222.21(2)(a) exemption.

Both the Eleventh Circuit and the District Court agreed with the Magistrate Judge's determination that Kearney forfeited the exempt status of the funds held in the IRA by pledging the funds as collateral in the Security Agreement. These courts reached this conclusion despite the fact the Security Agreement did not identify the IRA as part of the collateral. Instead, the courts determined Kearney's IRA was pledged as collateral because the Security Agreement provided Kearney pledged all of his "assets and rights." The dismissal of the exempt status of an IRA under Florida law by three Florida courts is alarming. The Magistrate Judge did not cite any Florida case law supporting its conclusion. The Magistrate Judge cited cases from the United States Court of Appeals for the Fifth Circuit, the United States Bankruptcy Court for the Southern District of Ohio, and the Eastern District Court of Virginia. In fact, Florida law does not support the conclusion reached by the court in *Kearney*. The cited cases were not decided under Florida law, are not binding on a Florida court, and rest in jurisdictions that do not necessarily have a state law exemption for IRA's.

3. Creates a toxic environment for new business. The ripple effects of the *Kearney* decision go beyond the loss of the statutory exemption for funds held in IRA's or qualified plans. *Kearney* comes to the absurd and misguided conclusion a Consumer waives all of the statutory exemptions under Florida law by signing a Security Agreement containing a blanket security interest provision. The conclusions reached by the Eleventh Circuit in *Kearney* are alarming for any person who has executed a general pledge of assets as collateral in any bank document. Mortgages, credit card applications, home equity line of credit agreements, security agreements, financing statements, and personal guarantees on business loans are only a few examples of documents that might include a general pledge of assets as collateral similar to the provision at issue in *Kearney*. Courts following the *Kearney* precedent could conclude a creditor or a bankruptcy trustee can reach other exempt assets, such as life insurance proceeds, annuities, or other qualified plans, because the Consumer waived the statutory exemption by signing a document containing a broad, general security interest provision. Millions of Florida Consumers are parties to at least one (if not more) of these contracts secured by their assets, which may now, unbeknownst to them, include a pledge of their exempt assets.

The committee is not proposing changes to the waiver process governing the homestead exemption or the wage exemption because they are clear and consistent with Florida Statutes Section 222.105. In Florida Statutes Section 222.11(2)(b), for a Consumer to waive protection from wage garnishment, the Consumer must consent to garnishment of such Consumer's wages in a writing in the same language, in 14-point type, signed by the consumer and the creditor. This writing ensures the Consumer understands they are waiving a statutory exemption.

A general pledge of assets should not allow a creditor to attach to those assets otherwise exempt under Florida law without a knowing waiver in writing specifying the specific exempt asset being pledged. The Florida legislature has previously recognized the significance of a waiver of a statutory exemption by requiring such waiver in a writing to ensure a Consumer knows and understands they are waiving a statutory exemption under Florida law. There is no Florida public policy for blindsiding millions of unsuspecting Consumers. Section 222.105 follows the general framework established under Section 222.11.

4. Triggers early distribution taxes and penalties of up to 40%. The tax result of the *Kearney* decision makes it even worse. Under federal law, if an IRA owner uses the account or any portion of such account as security for a loan, the portion used as security is deemed distributed to the owner. IRC § 408(e)(4). The IRA owner is required to include any amount paid or distributed out of the IRA (here it is deemed distributed) in gross income and to pay federal income taxes on such gross income. IRC § 408(d)(1). The same federal income tax results will occur if a Consumer pledges an interest in a qualified employer plan. Pursuant to § 72(p)(1)(B) of the Code, if a Consumer "pledges (or agrees to pledge) any portion of his interest in a qualified employer plan, such portion shall be treated as having been received by such individual as a loan from such plan." IRC § 72(p)(1)(B). A loan from a qualified employer plan is treated as being received as a deemed distribution for purposes of § 72. IRC § 72(p)(1). Additionally, the Code imposes penalties depending on when the deemed distribution from an IRA or qualified employer plan is made. Like an actual distribution, a deemed distribution is subject to the 10% additional tax on certain early distributions under § 72(t). Treas. Reg. § 1.72(p)-1, Q&A 11(b). For example, if a Consumer is under the age of 59 ½ and not disabled, the deemed distribution under § 408(e)(4) is also subject to the 10% penalty tax under § 72(t). IRC § 72(t).

The *Kearney* holding generates a calamitous financial result for Consumers. If a Consumer signs a bank document containing a broadly worded security interest provision, that Consumer, under *Kearney*, has arguably pledged the entirety of all such funds owned in an IRA, as well as their other exempt assets. As a result, the pledged funds held in the IRA will be treated as a loan taxable as a deemed distribution. The Consumer will pay federal income taxes on the distribution and may be subject to the aforementioned 10% penalty tax. If a creditor can garnish the funds held in an IRA, the debtor Consumer would, in addition to losing the pledged funds, be required to pay federal income taxes on all of the funds along with possibly the additional tax penalty for making an early distribution of the IRA!

The *Kearney* result flies in the face of the current statutory framework requiring a Consumer is to be made aware of, understand, and acknowledge that such Consumer is waiving a statutory exemption under Florida law. The Eleventh Circuit, without citing any Florida case law supporting its conclusion, potentially rendered moot numerous statutory exemptions from creditors contained in Chapter 222 of the Florida Statutes for any Consumer subject to Florida law who has signed any contract containing a broadly worded security interest provision. From a planning perspective, attorneys should meet with their clients to review the security interest provisions in all documents in which clients have pledged collateral as security, and advise them of the potential exposure of their exempt assets to creditors. In light of the serious issues resulting from the *Kearney* holding, Chapter 222 requires a legislative fix because a Consumer should not lose their exempt assets because the Consumer signed a document containing a blanket security interest provision.

5. Legislative fix needed: The Committee proposes the insertion of proposed Fla. Stat. § 222.105, which will clarify a Consumer can only waive the exemption from garnishment for funds held in an IRA or other qualified retirement account (Fla. Stat. § 222.21), proceeds from an annuity or life insurance contract (Fla. Stat. § 222.14), funds held in qualified tuition programs and other qualified accounts (Fla. Stat. § 222.22), and individual property exempt from the legal process (Fla. Stat. § 222.25) by making an express and knowing waiver in a writing containing identical terms to those set forth in the wage exemption under Fla. Stat. § 222.11(2)(b). This waiver must specifically reference the accounts or contracts in which the Consumer is waiving the exemption. In the case of an Individual Retirement Account or Qualified Retirement Account (as defined under Fla. Stat. § 222.21), the waiver should identify the Custodian as well as the last four digits of the corresponding account number. In the case of an annuity or life insurance contract (as defined under Fla. Stat. § 222.14), the waiver should identify the name of the insurer and the last four digits of the account or policy number. In the case of a qualified tuition program, the waiver should identify the name and type of qualified tuition program and the last four digits of the account number. In the case of other individual property (as defined under Fla. Stat. § 222.25), the waiver should make a specific reference to the individual property. The proposed statute includes Fla. Stat. § 222.25 within its purview, because the general pledge language in *Kearney* included "goods" as part of the collateral. The proposed statute does not refer to the wage exemption because the Committee believes the current statute contains protections similar to those being proposed herein. The proposed statute ensures a Consumer has sufficient notice and understanding regarding the decision to waive their right to a statutory exemption under Florida law.