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NYSTRS.org

Impact of a Member's Bankruptcy on NYSTRS Benefits

NYSTRS members may be compelled by adverse financial circumstances to consider filing for bankruptcy. This fact sheet provides basic information regarding the impact of bankruptcy upon a System member's benefit entitlements and on a loan a member may have obtained from the System. It is not intended to provide legal advice. A System member contemplating filing for bankruptcy is strongly urged to consult with his or her own attorney regarding any questions he or she may have about bankruptcy and its effect on his or her benefit entitlements and loans from the System.

Bankruptcy: Chapter 7 and Chapter 13

The two types of bankruptcy that are generally available to members are Chapter 7 and Chapter 13.

Under Chapter 7 bankruptcy, the debtor's non-exempt assets are liquidated, and the proceeds are used to pay creditors. This type of bankruptcy is often referred to as "liquidation."

Under Chapter 13 bankruptcy, the debtor gets to keep his or her assets, but agrees to devote all of his or her disposable income to pay creditors over a period of time, usually three to five years.

Any member considering bankruptcy is strongly urged to consult with an attorney.

Impact of a Member's Bankruptcy on Retirement Benefits

The System is a trust under New York law and the assets thereof are held for the exclusive benefit of System members. Under New York Education Law §524, the benefit interests of System members are not subject to the claims of creditors.

It is the System's position that a member's retirement benefit, until it is actually paid by the System, is not property that can become subject to creditors' claims in bankruptcy. This position is based upon the United States Supreme Court decision in Patterson v. Shumate, 504 U.S. 753 (1992), interpreting section 541(c) of the Bankruptcy Code. The System's position is supported by numerous recent court decisions.

Bankruptcy law also allows debtors who are in bankruptcy to exempt certain property from their bankruptcy estates. A System member who is domiciled in New York is able to exempt his or her retirement benefit in the System under exemptions provided by New York law. An amendment to the bankruptcy law in 2005 also allows a debtor in a Chapter 7 case filed on or after October 17, 2005 to exempt his or her retirement benefit in the System without regard to the state in which the debtor is domiciled.

A benefit, however, that has been paid by the System and received by the retiree or beneficiary prior to filing for bankruptcy may lose its character as a retirement benefit and may then be reachable by creditors, just like any other non-exempt asset of the debtor.

Impact of a Member's Bankruptcy on Outstanding Loans from the System

Member loans are not dischargeable (or "forgiven") in bankruptcy. A loan that a member obtains from the System is not a "loan" in the strict sense, but rather an advance on the member's retirement benefit, which does not give rise to a "debt," or establish a debtor-creditor relationship between the member and the System. In fact, the law that gives members the right to borrow against their accumulated contributions specifically states that the System may not bring a legal action against a member to enforce the amount due. In the event a member fails to repay the loan, the law provides that the System's sole remedy upon the member's retirement, withdrawal or death shall be to offset the outstanding loan amount, including interest, from a member's accumulated contributions or other benefits payable to the member or the member's beneficiaries.

A member's loan, therefore, is not a debt for purposes of bankruptcy, and is therefore not dischargeable in bankruptcy. This principle has been expressly recognized by the courts. Because member loans are not dischargeable in bankruptcy, the System, therefore, is not stayed from collecting a member's loan payment by the filing of a bankruptcy petition. Accordingly, the System has the right to collect a member's loan payments through automatic payroll deduction even though the member has filed for bankruptcy.

Under Chapter 13 bankruptcy, a debtor is required to devote all disposable income to repay creditors. An active member of the System cannot be required to borrow from the System or draw a benefit in order to create disposable income. However, the monthly retirement benefit of a retired member who enters Chapter 13 bankruptcy may be treated as disposable income.

A System member in a Chapter 13 case filed prior to October 17, 2005 may have income needed to repay a NYSTRS loan treated as disposable income and may be required to default on the NYSTRS loan. However, as a result of an amendment to the bankruptcy law in 2005, a System member in a Chapter 13 case filed on or after October 17, 2005 will not have income needed to repay a NYSTRS loan treated as disposable income and will not be required to default on the NYSTRS loan.

Explanation of Key Terms

Disposable Income, as defined by the United States Bankruptcy Code §1325, is *income which is received by the debtor and which is not reasonably necessary to be expended for the maintenance and support of the debtor or a dependent of the debtor*. In other words, disposable income is any income a Chapter 13 debtor receives which is over and above the amount that must be devoted to providing the necessities of life (food, shelter, clothing, etc.).

New York Education Law §524 states, "The right of a teacher to a pension, an annuity, or a retirement allowance, to the return of contributions, any benefit or right accrued or accruing to any person under the provisions of this article, and the moneys in the various funds created hereunder, are hereby exempt from any state or municipal tax, and shall not be subject to execution, garnishment, attachment or any other process whatsoever, and shall be unassignable except as in this article specifically provided."

Default: A member is subject to certain consequences if he or she defaults on his or her NYSTRS loan:

- The member forfeits the right to borrow again until the loan balance is paid in full.
- Upon default, the unpaid balance may be treated as a taxable distribution by the Internal Revenue Service (IRS).
- The IRS imposes an additional 10% penalty on the taxable portion of the unpaid balance if the member is under age 59 ½.
- The unpaid balance continues to accrue interest charges, and if the balance remains unpaid when the member retires, the member's retirement benefit will be reduced.