THE INTERPLAY BETWEEN PRE-BANKRUPTCY ASSET PROTECTION AND A DEBTOR'S ENTITLEMENT TO A DISCHARGE

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I. Legislative History to the Bankruptcy Reform Act of 1978 (the "Bankruptcy Code") and Legal Background

A. The legislative history to the Bankruptcy Code expressly authorizes the conversion of non-exempt to exempt assets on the eve of bankruptcy. It states in pertinent part:

> As under current law, the debtor will be permitted to convert non-exempt property into exempt property before filing a bankruptcy petition. The practice is not fraudulent as to creditors, and permits the debtor to make full use of the exemptions to which he is entitled under the law.

H.R.Rep.No. 595 95th Cong., 1st Sess. 361 (1977), reprinted in 1978 U.S. Code Cong. & Ad. News 5963, 6317; S.Rep.No. 989, 95th Cong., 2d Sess. 76, reprinted in 1978 U.S. Code Cong. & Ad. News 5878, 5862.

B. Collier on Bankruptcy has interpreted this legislative history as authorizing a liberal approach to the conversion of non-exempt property into exempt property, especially in those jurisdictions where the exemption allowance is minimal. Notwithstanding the expansive language of the legislative history, and Collier's interpretation thereof, courts have interpreted the phrase "as under current law" to qualify such a blanket authorization, and to limit debtor's right to exemption

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if there is found "extrinsic evidence of actual intent to defraud." See In re Reed, 700 F.2d 986 (5th Cir. 1983).

C. Thus, the apparent certainty of the legislatively-created bright line test is significantly clouded by the concept that if the conversion of assets, otherwise allowable to maximize a debtor's exemptions, is accompanied by "extrinsic fraud", then such transfer is tainted.

D. In re Reed, 700 F.2d at 986. The seminal case of In re Reed involved an individual debtor who, two months prior to the filing of his bankruptcy petition raised $45,000.00 by the sale of certain non-exempt collectibles, and utilized those funds to pay down certain mortgages on his home, fully exempt under Texas law. Additionally, the debtor could not account with any level of detail for the disposition of some $19,586.83 in cash admittedly in his possession during the same period.

1. The Fifth Circuit affirmed the findings of actual intent to defraud and held that such findings were "not permeated with error." in holding:

> The denial of discharge on this ground alone was appropriate. It would constitute a perversion of the purposes of the Bankruptcy Code to permit a debtor earning $180,000.00 per year to convert every one of his major non-exempt assets into sheltered property on the eve of bankruptcy with actual intent to defraud his creditors and then emerge washed clean of future obligations by careful concocted immersion in bankruptcy waters.

700 F.2d at 992.

Query: - - How much of the Fifth Circuit decision is predicated upon (a) the debtor's pre-bankruptcy income level, or (b) the debtor's failure to provide a sufficient explanation as to the dissipation of the $19,586.83 in cash (other than claiming he spent most of it, did not obtain receipts for those expenditures and gambled a portion)?

Query: - - If the debtor merely sold his collectibles to pay down his mortgage and the other factors were absent, would the result have been different?

II. Second Circuit Authority

A. In re Adlman, 541F.2d 999 (1976). Although decided under the Bankruptcy Act (the predecessor to the Bankruptcy Code), Adlman continues to remain the standard in the Second Circuit in evaluating the transfer of non-exempt into exempt assets on the eve of bankruptcy.

1. Facts of Adlman. Five and one-half months prior to the filing of a bankruptcy petition, the debtor sold the family home in Sands Point to her husband's aunt and uncle for the sum of $125,000.00, subject to an existing first mortgage. A lease was entered into between the relatives and the debtor and her husband, to enable them to continue to live in their home. The Debtor realized approximately $60,000.00 from the sale which she utilized to pay $52,653.00 on loans borrowed against outstanding insurance policies and to pay $7,663.22 in premiums on these policies. The justification for the utilization of all the net proceeds of sale was that the debtor's husband was in poor health and she could not allow the life insurance policies to lapse. She also testified that she believed that her husband's business would improve, her husband being the only breadwinner in the family. A creditor objected to the Debtor's discharge, and after an evidentiary hearing, the Bankruptcy Court concluded that as to Mrs. Adlman, the transfer of her house, the repayment of insurance policy loans, the payment of insurance premiums were all done with the intent to hinder, delay or defraud her creditors, and entered an order denying her discharge.

2. The Second Circuit reversed the Bankruptcy Court, holding

that the Bankruptcy Judge "made no findings of extrinsic facts to support the conclusion that there was an actual intent to defraud . . . creditors."

3. Dissent. Justice Moore dissented from the majority opinion on the grounds that the only basis to reverse the factual findings of the Bankruptcy Judge was if same were "clearly erroneous." Judge Moore stated:

> "On the contrary, it is amply supported by the testimony presented to the Court, and the undisputed facts alone are indicative, of a scheme to defraud creditors. The sale and leaseback was not an arms length transaction; the immediate conversion of the proceeds into exempt property was not for the purpose of paying premiums due and owing on the policy, but rather for the prepayment of future premiums. It is conceded that the bankrupt was counseled in this course of action by a spouse who was an experienced, albeit not necessarily successful businessman. The court could fairly infer from all of the above that there was actual intent to place assets beyond the reach of creditors, and under such circumstances discharge was properly denied."

III. Authority in Other Circuits

A. In re Smiley, 864 F.2d 562 (7th Cir. 1989).

1. In Smiley, the Seventh Circuit rejected case law which held that where a debtor intended to keep assets away from creditors, such motivation would preclude the debtor's entitlement to a discharge. See e.g. In re Ford, 53 B.R.444 (W.D.Va. 1984), aff'd. sub nom, Ford v. Posten, 773 F.2d 52 (4th Cir. 1985). The court concluded that such analysis, as set forth in the aforecited cases would "favor ignorant

debtors and punish knowledgeable debtors."

2. Discharge ultimately denied, not because the Debtor invested his money into an unlimited Kansas homestead, but because he lied to his creditors about the retained valued of his assets that had been liquidated. See also Ford v. Posten, 773 F.2d at 52.

B. In re Sholdan, 217 F.3d 1006 (8th Cir. 2000).

1. In Sholdan, the debtor, a retired farmer, 90 years of age was afflicted with serious medical problems. He was named as a defendant in a personal injury action, and as a consequence, liquidated his bank account, certificate of deposit and mortgage rights, using the proceeds to purchase a home worth $135,000.00 in value. The Eighth Circuit affirmed the Bankruptcy Court's decision finding ample evidence of extrinsic fraud sufficient to deny the Debtor his discharge.

2. In a strong dissent, Circuit Judge Arnold concluded that the Debtor did no more than transfer non-exempt assets to exempt assets on the eve of bankruptcy, and to the extent that it was consistent with legislative history to the Bankruptcy Code, then such could not be evidence of extrinsic fraud.

C. Marine Midland Bus. Loans, Inc. v. Carey, 938 F.2d 1073 (10th Cir. 1991).

1. In Carey, the Debtor transferred a series of non-exempt assets to reduce his mortgage against his homestead, leaving him with a homestead worth $300,000.00 subject only to a $30,000.00 mortgage. The Tenth Circuit affirmed the Bankruptcy Court and District Court's

finding there was no improper intent and granting the Debtor a discharge.

IV. Interrelationship Between Entitlement to a Discharge and Exemptability of Assets

A. Collier on Bankruptcy concludes that the "eleventh hour acquisition of exempt property will not require disallowance of an exemption in the property." 4 Collier on Bankruptcy (¶ 522.08[4]) (15th Ed.).

B. In Norwest Bank Nebraska, N.A. v. Tveten, (In re Tveten), 848 F.2d 871 (8th Cir. 1988), Circuit Judge Timbers, sitting by designation, authored the opinion of the Court. In it, he drew a distinction between the debtor's right to a discharge and his ability to exempt assets acquired to benefit from an exemption provision. Judge Timbers reasoned:

> "While state law governs the legitimacy of Tveten's exemptions, it is federal law that governs his discharge. Permitting Tveten, who earns over $60,000.00 annually, to convert all of his major non-exempt assets into sheltered property on the eve of bankruptcy with actual intent to defraud his creditors 'would constitute a perversion of the purposes of the Bankruptcy Code.' In re Reed, 700 F.2d at 992. Tveten still is entitled to retain, free from creditors' claims, property rightfully exempt under relevant state law."

Id. at 876. See Goggin v. Dudley, 166 F.2d 1023 (9th Cir. 1948) (purchase of exempt asset one week piro to filing did not affect its exempt status.)

1. Query: What is impact of a Debtor's claim of a right to a federal exemption?

Compare, In re Meyer, 206 B.R. 410 (Bankr. E.D.Va. 1997) (debtor's liquidation of personal assets to pay down mortgage against homestead owned by debtor and spouse enabled the recovery of proceeds paid to mortgagee.); In re Lynch, 321 B.R. 114 (Bankr. S.D.N.Y 2005) (if annuity created

to obtain a "head start," the exemption would be disallowed.)

V. Ability to Exempt an Asset in the Face of Claim that it Was Obtained With Intent to Defraud Creditors

A. In re Keating, 2006 U.S.Dist. LEXIS 70980 (E.D.N.Y. 2006).

Facts:

1. The Debtor, a 72 year old part-time adjunct professor, suffering from heart disease and prostate cancer, owned a co-op with equity of approximately $120,000.00 to $170,000.00.

2. The Debtor transferred the co-op, placing the net proceeds thereof in an annuity which would pay to him $1,321.57 monthly for the rest of his life.

3. The Debtor waited 6 months and 4 days after he purchased the annuity to file for bankruptcy (if the Debtor would have filed within 6 months of the purchase of the annuity, Debtor Creditor law Section 283 would have limited his exemption to $5,000.00).

4. The strategy, guided by his cousin, an insurance agent, and a financial planner, was found by the bankruptcy court to be, "part of a plan to keep the proceeds from the co-op sale beyond the reach of his creditors." However, the bankruptcy court also found that the Debtor's "age and medical condition were legitimate reasons supporting the purchase of the annuity, compromising a finding of actual intent to defraud."

5. The bankruptcy court was also influenced by "the up-front and arms length nature of the annuity purchase."

6. Eastern District Judge Seybert held: "Utilizing available exemptions and engaging in pre-petition planning, without more is not indicative of actual intent to defraud creditors." The court further stated "It is not unusual for debtors to convert substantially all of their non-exempt assets into exempt property on the eve of bankruptcy." The court concluded "This practice is not fraudulent as to creditors, and permits the debtor to make full use of the exemptions to which he is entitled to under the law." See In re Robinson, 271 B.R. 437 (Bankr. N.D.N.Y. 2001) and In re Moore, 177 B.R. 437 (N.D.N.Y. 1994).

B. In re Martiny, 378 B.R. 2007 (Bankr. W.D.N.Y. 2007)

Facts:

1. Prior to the filing of their bankruptcy petition, on May 8th, 2007, joint debtors used $36,000.00 of otherwise non-exempt assets to reduce the balances due on the mortgages against their home. The Debtors moved immediately in their bankruptcy case to compel the Trustee to abandon the estate's interest in the homestead, so as to enable the Debtors to close on a pre-petition contract of sale that would yield $67,000.00 in net proceeds for the Debtors' mutual benefit. The Debtors' motion was granted, and by agreement, the net proceeds were escrowed.

2. Bankruptcy Judge Carl L. Bucki made short shrift of the Trustee's argument that the pre-bankruptcy planning resulted in a much more substantial homestead exemption. Judge Bucki, relying upon the legislative history to the Bankruptcy Code, summarily concluded that such planning was permissible and manifested no evidence of extrinsic fraud.

C. In re Lynch, 321B.R. 114 (Bankr. S.D.N.Y. 2005)

1. The Debtor, a 78 year old semi-retired attorney settled a personal injury action, and instead of obtaining a lump sum contingency fee, joined his client in receiving his compensation in installments over time. On this basis, the Debtor claimed that the payment stream constituted an annuity exempt in full (insofar as he filed his petition after waiting more than six months).

2. The annuity together with the Debtor's other income and social security payments aggregated $3,365.43 per month. The Trustee acknowledged that the annuity was necessary to cover the Debtor's necessary living expenses. This acknowledgment prompted Judge Liftland to conclude "It is unclear why the Trustee lodged the objection at all."

3. At the same time, the court expressed some concern that an attempt to exempt an annuity of greater magnitude could promote a "head start" rather than a "fresh start", concluding that in the event a trustee could establish that the creation of the annuity was undertaken with the intent to hinder, delay or defraud creditors, "such intent might taint the exempt status of such annuity." See also In re Stahlman, Case No. 01-82200-478 (Bankr. E.D.N.Y. 2001) (Eisenberg, J.)

VI. Conclusion

A. While the law in the Second Circuit is generally favorable, no Second Circuit decision has tested the perimeters of the Doctrine. In light of cases such as Reed, its progeny, Sholden, Tveten, etc., there is no bright line test, and any advice as to the ability of a Debtor to augment his

exemptions on the eve of bankruptcy must by necessity be temperate, and unfortunately, somewhat equivocal.

B. With respect to the ability to purchase exempt assets of substantial value, such as annuities, on the eve of bankruptcy, the relative uniformity of the case law could encourage a practitioner to advise a client to purchase such asset with some level of comfort. However, the cases all share a factual similarity insofar as the debtors claiming the exemption are largely elderly, have modest assets, are often infirm, and do require the annuity to aid in their lifestyle. Thus, to the extent that the amount sought to be exempted is meaningfully larger, the level of certainty as to an attorney's advice may diminish.