Advanced Chapter 7 Track:
Part 2

Concurrent Session

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Advanced Chapter 7 Track – Part 2:

Tax Refunds and Returns

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Advanced Chapter 7 Track – Part 2:
Tax Returns and Refunds

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I. TAX RETURNS

A. THE SHORT TAX YEAR, § 1398 ELECTION

Congress recognized the need to accommodate tax policy with the debtor's right to a fresh start, providing the debtor an election to shorten or end the tax year as of the day before the date in which the petition is filed. This election is limited to individual Chapter 7 or 11 Debtors, 26 U.S.C.S. § 1398(a); the Debtor's spouse may also join in the election. If the election is made, the Debtor's tax year is divided into two short tax years. The first tax year would begin January 1st and would end the date before the commencement date (presuming the Debtor is a calendar-year tax payer), 26 U.S.C. § 1398(d)(2)(A)(i). The second tax year begins the date the petition is filed and ends December 31st of that year, 26 U.S.C. § 1398(d)(2)(A)(ii). The result of this election would make any tax liability an allowable, pre-petition claim against the estate, rather than against the debtor.[1]

A debtor makes the election by filing Form 1040 and writing "Section 1398 Election" at the top of the return or by attaching a statement to Form 4868 which must be filed by the due date for the return of the first tax year.[2] The return for the first tax year is due on or before the 15th day of the fourth month after the end of that first tax year; the end of

[1] Election under § 1398 prohibited unless the trustee administering non-exempt assets for the benefit of the estate. 26 U.S.C. § 1398(d)(2)(C).

[2] Department of the Treasury (I.R.S.). Bankruptcy Tax Guide, Publication 908. (Mar. 2009).

the tax year is the day before the petition date. Once the election is made, it is irrevocable unless the bankruptcy is dismissed. The debtor must also file a second Form 1040 for the second short tax year no later than April 15th of the following year.

This shortened tax year can also benefit a non-filing spouse. The non-filing spouse has the option of filing a joint return to end the tax year or may file separately at the end of the calendar-year. If a joint election to close the tax year is made, then a joint return must filed for the first short tax year, 26 U.S.C. § 1398(d)(2)(B). However, the debtor and the spouse need not file a joint return for the end of the second short tax year. The IRS has provided guidance when the shortened tax year is applicable:

> If the debtor's spouse files for bankruptcy later in the same year, he or she may also choose to end his or her tax year, regardless of whether he or she joined in the choice to end the debtor's tax year. Because each of them has a separate bankruptcy, one or both of them may have 3 short tax years in the same calendar year. If the debtor's spouse joined in the debtor's choice, or if the debtor had not made the choice to end the tax year, the debtor can join in the spouse's choice. But if the debtor made an election and the spouse did not join in the election, the debtor cannot join in the spouse's later election. This is because the debtor and the spouse have different tax years. The debtor does not have a tax year ending the day before the spouse's filing for bankruptcy, and the debtor cannot file a joint return for a year ending on the day before the spouse's filing of bankruptcy. Department of the Treasury (I.R.S.). Bankruptcy Tax Guide, Publication 908. (Mar. 2009).

Examples:

By way of example for calendar-year tax payers: Debtor files his chapter 7 petition on April 10th. If Debtor makes an election, his first short tax year is January 1-April 9, and his second short tax year begins on April 10th. His second shortened tax year is April 10-December 31. His spouse could join in the election as long as a joint return is filed for the January 1-April 9 tax year. The election must be made by August 15th.

Another example provides for the debtor filing his chapter 7 petition on March 5, and his wife filing her chapter 7 petition on October 1 of the same year. If the debtor did not

make an election to end his tax year on March 4th, or if the debtor did so but the spouse did not join in an election, then the spouse could choose to end her tax year on September 30th. Her first short tax year is January 1-September 30, and her second short tax year is October 1-December 31. Additionally, if the debtor did not end his tax year March 4, then he could join in his spouse's election to end the tax year on September 30, which would require them to file a joint return for the first short tax year January 1-September 30. If the debtor did make an election to end his tax year March 4 but his spouse did join in his choice, then he could not join his wife in her election to end the tax year on September 30th. The reason is that they could not file a joint return for that short year as their tax years were not the same.

A third example provides that for the debtor filing his chapter 7 petition on May 9th, and the spouse filing her chapter 7 petition on October 2nd of the same year. Debtor elects to end his tax year on May 8th and his spouse joins in the election. The spouse could potentially have three short tax years. The first tax year would be January 1-May 8; the second, May 9-October 1; the third being October 2-December 31. Additionally, the debtor could join the spouse's election *if they filed a joint return for the second tax year* (May 9-October 1) and have the same 3 short tax years. While the debtor and spouse may file a joint return for the third tax year, they are not required to do so.[3]

Debtors can alleviate income tax liability incurred during the year in which the petition was filed by making a § 1398 election. In making a timely election, the tax liability becomes an allowable pre-petition claim against the bankruptcy estate.

[3] Examples derived from Department of the Treasury (I.R.S.). Bankruptcy Tax Guide, Publication 908. (Mar. 2009).

Conversely, if a debtor fails to make the election, the tax liability for the entire tax year is collectable directly from the individual debtor, not the estate. *Skiba v. Knee (In re Knee),* 2006 Bankr. LEXIS 2417 (Sept. 12, 2006)*; In re Haedo,* 211 B.R. 149 (Bankr. S.D. N.Y. 1997); *In re Smith,* 210 B.R. 689 (Bankr. D. Md. 1997); *In re Moore,* 132 B.R. 533 (Bankr. W.D. Pa. 1991); *In re Mirman*, 98 B.R. 742 (Bankr. E.D. Va. 1989).

- Tax liability, although listed on Schedule E as a priority debt, resulting from pre-petition sale of property was not a claim payable from the bankruptcy estate as the debtor failed to make the an election under section 1398. *Skiba v. Knee (In re Knee)*, 2006 Bankr. LEXIS 2417 (Bankr. W.D. Pa. Sept. 12, 2006).
- Tax liability arose post-petition as debtor failed to split the tax year. Debtor could not apply tax refund to bankruptcy estate funds for liability arising out of a post-petition tax year as the debtor failed to split the tax year. *In re Fleming*, 277 B.R. 751 (Bankr. S.D. Ohio 2002).
- Tax liability could only be assessed against the debtor, not against bankruptcy estate, as the debtor did not timely make a Section 1398 election. *In re Prativadi*, 211 B.R. 149 (Bankr. S.D. N.Y. 1997).

The following cases have also provided direction in analyzing § 1398 and the shortened tax year. *See In re Eith,* 111 B.R. 311 (Bankr. D. Haw. 1990); *In re Gonzalez,* 112 B.R. 10 (Bankr. E.D. Tex. 1989*)*; *In re Turboff,* 93 B.R. 523 (Bankr. S.D. Tex. 1988); *In the Matter of Santiago Vela,* 87 B.R. 229 (Bankr. D. Puerto Rico 1988).

B. AVOIDING REPORTABLE INCOME FROM THE CANCELLATION OF DEBT, FORM 982.

Cancellation of debt occurs when a lender cancels or forgives a debt. The lender reports the cancelled debt by the filing of Form 1099-C. Generally when an obligation is forgiven, the tax payer must report the cancelled amount as income. However, the cancellation of debt is not always taxable. Some exceptions include:

- Qualified personal residence indebtedness created by the Mortgage Debt Relief Act of 2007, which includes mortgage debt forgiven through 2012.
- Non-recourse loans: loans in which the sole remedy for default is the return of property or repossession.
- Insolvency: a tax payer is insolvent when the total debts exceed the fair market value of all assets.
- Bankruptcy: Debts discharged in bankruptcy are not considered taxable income.

Most lenders are required to file a Form 1099-C reporting the cancellation of debt. The income resulting from the reported cancellation of debt *will not be taxable* for debtor that receives a discharge under title 11 of the Bankruptcy Code. However, the debtor is still required to *report the forgiveness of debt* by the filing of Form 982 which must be attached to the tax return. One may obtain this form by following the link: www.irs.gov/pub/irs-pdf/f982.pdf

II. TAX REFUNDS

A. AN ASSET OF THE ESTATE.

The deadline in which to file a list of assets on the schedules is within 14 days from the date the petition was filed. FRBP 1007(c). Subsequent amendments are governed by

FRBP 1009(a) which provides that a debtor may amend "[a] voluntary petition, list, schedule, or statement may be amended… as a matter of course at any time before the case is closed." *Lucius v. McLemore,* 741 F.2d 125 (6th Cir. Tenn. 1984). Courts have construed this rule to provide a liberal allowance of amendments, absent a finding of bad faith, concealment, or prejudice to creditors. *Kaelin v. Bassett (In re Kaelin),* 308 F.3d 885 (B.A.P. 8th Cir. 2002). When addressing the issue of bad faith, bankruptcy court judge for the Eastern District of Michigan (Judge Steven Rhodes) has stated that the "disclosure[] obligations of consumer debtors are at the very core of the bankruptcy process and meeting such obligations is part of the price debtors pay for receiving the bankruptcy discharge." *In re Colvin*, 288 B.R. 477, 481 (Bankr. E.D. Mich. 2003). Ultimately in *Colvin,* the amendments were disallowed after examining the totality of the circumstances and finding that the debtors acted in bad faith.

Property of the estate has been defined pursuant to 11 U.S.C. § 541(a)(1) as "all legal or equitable interests of the debtor in property as of the commencement of the case." *Owen v.Owen*, 500 U.S. 305, 308 (1991). Tax refunds arising from pre-petition earnings constitute property of the estate. *Araj v. Kohut*, 371 B.R. 240, 243 (Bankr. E.D. Mich. 2007); *Bailey v. Suhar,* 380 B.R. 486 (B.A.P. 6th Cir. 2008); *Johnston v. Hazlett*, 209 F.3d 611 (6th Cir. 2000); *Kokaszka v. Bedford,* 417 U.S. 642 (1974); *Segal v. Rochelle,* 382 U.S. 375 (1966)(although holding later codified in Section 346(i)(3), reasoning applicable to any property with a contingent, future interest).

Debtors have attempted to exclude from the bankruptcy estate portions of the income tax refund attributable to allowable credits and deductions allowable under the Internal

Revenue Code. Below is a breakdown of credits and deductions available under the tax code litigated in the bankruptcy context.

1. Child Tax Credit:

The Child Tax Credit (the "CTC") has refundable and nonrefundable components. The nonrefundable portion is simply used to offset or reduce the amount of tax liability; the refundable portion is a tax overpayment, which constitutes estate property to the extent that it is non-exempt. The court *In re Molina* determined that the debtors, having received the benefit of reducing their liability with the nonrefundable portion of the CTC, could not also exempt the same portion of the CTC. The court sustained the trustee's objection requiring turnover of the non-exempt portion of the income tax refund. *In re Molina,* 2009 Bankr. LEXIS 1509 (Bankr. N.D. Ohio, 2009); *In re Zingale*, 2011 Bankr. LEXIS 2174 (6th Cir. 2011)(CTC did not constitute a "payment" under Ohio law, and only the portion of the CTC that was refunded could be exempted under Ohio's exemption statutes); *In re Baylosis,* 2007 Bankr. LEXIS 1450 (Bankr. E.D. Tenn. 2007)(CTC, a contingent interests, falls within definition of estate property under § 541); *In re Minton,* 348 B.R. 467 (Bankr. S.D. Ohio, 2006). *Contra In re Patterson*, 2010 Bankr. LEXIS 2899 (Bankr. N.D. Ohio, Sept. 10, 2010)(portion of tax refund attributable to child tax credit and earned income credits retained exempt status under Ohio law, and was therefore, not part of bankruptcy estate).

2. Earned Income Credit:

The Earned Income Tax Credit (hereinafter "EITC")[4] was created at the federal level as a work incentive and income redistribution program. This credit was to provide an incentive to welfare recipients or other individuals that work but have low wages to gain and/or maintain employment. The EITC is a refundable tax credit that supplements earnings of such low-income workers. The credit may be used to offset tax liability or may result in a refund should the credit exceed the amount of liability. The amount of the credit is dependent upon the amount of earnings and the number of children in the household.

One of many requirements is that a taxpayer must have earned income in order to use this credit. Several courts have rejected arguments that EITC should be excluded from the estate as a type of public assistance benefit. EITCs are treated as overpayments, and are thus, included as property of the estate. *Johnson v. Hazlett*, 209 F.3d 611, 613 (6th Cir. 2000); *In re Parker*, 352 B.R. 447 (Bankr. N.D. Ohio 2006); *Baer v. Montgomery (In re Montgomery),* 219 B.R. 913 (B.A.P. 10th Cir. Kan. 1998), aff'd, 224 F.3d 1193 (10th Cir. 2000) (EITCs are property of the estate, relying in part on case law which held that Congress amended the Internal Revenue Code to treat EITCs as tax overpayments, which are to be refunded and included in the debtor's estate). *Contra In re Patterson*, 2010 Bankr. LEXIS 2899 (Bankr. N.D. Ohio Sept. 10, 2010)(portion of tax refund attributable to child tax credit and earned

[4] 26 U.S.C. § 32(a) Allowance of credit.--(1) In general.-- In the case of an eligible individual, there shall be allowed as a credit against the tax imposed by this subtitle for the taxable year an amount equal to the credit percentage of so much of *the taxpayer's earned income* for the taxable year as does not exceed the earned income amount (emphasis added).

income credit retained exempt status under Ohio law, and was therefore, not part of bankruptcy estate).

3. First-Time Homebuyers Credit:

Debtor filed a joint income tax return with his non-filing spouse, claiming a first-time homebuyer's credit of $8,000.00 that was included as part of their refund. The non-filing spouse did not have any taxes withheld. The non-filing spouse's interest ($4,000.00 of the $8,000.00) in the first-time homebuyer credit, allowed under 26 U.S.C. § 36, is not limited to taxes withheld, and therefore, the credit was not part of the debtor's bankruptcy estate. However, the $4,000.00 portion of the credit due to the debtor did constitute part of his estate and was recoverable by the Trustee. *In re McCrory,* 2011 Bankr. LEXIS 3403 (Bankr. N.D. Ohio Sept. 8, 2011)**.**

4. Net-Operating Loss:

In the context of a chapter 11, court denied sale of stock which would impair the net-operating loss, as NOL an asset of the estate entitled to protection. *In re Phar-Mor, Inc.,* 152 B.R. 924 (Bankr. N.D. Ohio 1993).

B. STATUS OF TAX REFUND AS ESTATE PROPERTY UPON CONVERSION FROM CHAPTER 13.

The Bankruptcy Reform Act of 1994 resolved a split of decisions whether property acquired post-petition, pre-conversion became property of the chapter 7 estate. BAPCPA Code § 348(f)(1)(A) states when a chapter 13 case is converted to a case under another chapter, the "property of the estate in the converted case shall consist of property of the estate, as of the date of filing of the petition, that remains in the possession of or is under the control of the debtor on the date of conversion[.]" *In re Erchenbreacher,* 85

B.R. 42 (Bankr. N.D. Ohio 1988). The exception to the petition date is a case converted in bad faith, then the property of the estate "consist[s] of property of the estate as of the date of conversion." 11 U.S.C. § 348(f)(2). Unquestionably, pre-petition wages or earnings are property of the estate. However, a tax refund that accrued post-petition but prior to the conversion date is not an asset of the chapter 7 estate. *Taylor v. Burns*, 344 B.R. 523, 525 (Bankr. W.D. Ky. 2004)(wages earned after the chapter 13 petition date were not property of the chapter 7 estate); *Cf In re Dean*, 2000 Bankr. LEXIS 1872 (Bankr. E.D. Ky. Jan. 12, 2000)(chapter 13 pre-confirmation plan payments were not property of the chapter 7 estate).

C. THE SPOUSE'S PROPERTY INTEREST IN INCOME TAX REFUND.

As noted above in Section IIA, the tax refund is an asset of the estate. *Araj v. Kohut,* 371 B.R. 240, 243 (Bankr. E.D. Mich. 2007). The court in *Araj* held that it was appropriate to pro-rate the amount of the refund to the date of filing the bankruptcy petition to determine the pre-petition portion. *Id.* at 244; *In re Meyers*, 2010 WL 2990826 (7th Cir. 2010). The amount of the tax refund pro-rated to determine the pre-petition portion, and thus, an asset of the estate, should not be confused with the issue of property rights of each spouse.

Courts have taken three approaches to determine the issue of tax refund ownership and the amount that constitutes property of the estate recoverable by the Trustee. The majority of courts allocate the tax refund arising from a joint tax return proportionately according to the amount of tax withholdings. Another approach allocates joint tax refunds proportionately according to the amount of income produced by each spouse. A

third approach allows each spouse to share equally in the refund, regardless of whether income was produced or taxes withheld.

1. Majority Approach – The Withholding Rule

Married individuals are permitted to file a joint tax return under 26 U.S.C. Section 6013(a) for the purpose of equalizing their tax burden. It does not, however, change the ownership or property rights in the portion of the refund the debtor would have received had the debtor filed an individually. *United States v. Macphail,* 149 Fed. Appx. 449 (6th Cir. Ohio 2005) (finding in a non-bankruptcy context that a joint income tax return does not create new property interests for the husband or the wife in each other's income tax overpayment). While state law determines an individual's interest in property, federal law determines property of the bankruptcy estate.

For a married spouse filing an individual bankruptcy, the question is whether the tax refund is estate property. Any tax overpayment made pre-petition is owned by the wage-earning spouse and is property of the debtor's *estate*. Trustees have moved for turnover of tax refunds as property of the estate when the non-filing spouse without earnings claims an interest in the tax refund consisting of overpayment derived solely from the debtor. *In re McCrory,* 2011 Bankr. LEXIS 3403 (Bankr. N.D. Ohio Sept. 8, 2011)(Non-filing spouse, that earned income but had no taxes withheld, was not entitled to claim an exemption in the income tax refund); *Monticello Arcade Ltd.Partnership v. Lyall* (*In re Lyall),*191 B.R. 78, 84 (Bankr. E.D. Va. 1996).

The majority position remains unchanged when married individuals file a joint bankruptcy petition. In jointly administered cases, the focus is not whether the tax

refund is an asset of the estate, but which spouse may claim an exemption, if at all. Married individuals are permitted to file a joint petition under 11 U.S.C. § 302(a) and FRBP 1015(b), which provides the trustee with procedural convenience and prevents duplicating efforts in the administration of two related estates. Joint administration should not be confused with consolidation; consolidation creates one estate from the two or more estates per order of the court pursuant to 11 U.S.C. § 302(b). Despite the joint administration of a jointly filed petition, two separate estates are created. From this, each debtor is only entitled to *claim an exemption* in the assets of his or her estate, the same as if two separate petitions had been filed. *In re Gazvoda,* 2011 Bankr. LEXIS 2786 (Bankr. N.D. Ohio July 21, 2011). Trustees are required to keep separate accounts of the property and distribution of each estate pursuant to FRBP 2009(e).[5] Accordingly, if a trustee is successful in recovering a tax refund that derived from the withholdings of only one debtor, then it would follow that the trustee must make distributions to the creditors of that estate only. Trustees have been successful in their objections of an exemption taken by the co-debtor that have not had any tax withholdings for the given tax year. *In re Gazvoda,* 2011 Bankr. LEXIS 2786 (Bankr. N.D. Ohio July 21, 2011); *In re Carlson,* 394 B.R. 491 (B.A.P. 8th Cir. 2008). The court in *McEachern* followed the withholding rule, sustaining the trustee's objection to the wife's exemption as income was derived solely from the husband, despite the fact that the refund was deposited into a joint checking account. *In re McEachern,* 2005 Bankr. LEXIS 2140 (Bankr. N.D. Ohio 2005). The fact that a tax refund check is made out to both debtors, jointly as husband and wife, also does

[5] Further evidencing the existence of two separate estates, creditors even have a right to elect a separate trustee for the estate of one debtor in a case being jointly administered pursuant to FRBP 2009(b).

not alter the underlying property rights in the proceeds when following this position. *In re Smith,* 77 B.R. 633 (Bankr. N.D. Ohio 1987).

2. 50/50 Refund Rule:

Another approach used by courts allow each spouse to retain one-half of the income tax refund regardless whether a spouse earned income or had withheld taxes. These courts have looked toward state law governing entireties property and the equities in a given set of circumstances on a case by case basis, subject to a rebuttable presumption. Factors considered are the history of the use of tax refund, co-mingling of the asset, and the value of uncompensated services and substantial contribution by the spouse. Some courts have sought guidance from the domestic relation laws of its state and the division of assets in a divorce.

In following the 50/50 Rule, the court in *McKain* determined that the income tax refund was property owned as tenants in the entireties even though non-filing spouse had no taxes withheld from her social security income. The court considered the spouses' express intent to hold the property in that manner and determined that Virginia law presumes that when a husband and wife file a joint return, the property interest in resulting refund is owned equally. *In re McKain,* 2011 Bankr. LEXIS 2831 (Bankr. E.D. Tenn. July 22, 2011). *See Bass v. Hall,* 79 B.R. 653, 656 (W.D. Va. 1987)(jointly administered bankruptcy); *In re Garbett,* 410 B.R. 280 (Bankr. E.D. Tenn. 2008)(Trustee failed to rebut the presumption that each debtor was not one-half owner of refund when debtors comingled their income, deductions, exemptions, taxes, and held refund as tenants in the entireties even though no taxes withheld by

husband); *In re Trickett,* 391 B.R. 657 (Bankr. D. Mass. 2008); *In re Innis,* 331 B.R. 784 (Bankr. C.D. Ill. 2005)(state law determines a debtor's right in a tax refund, court adopting 50/50 rule without a rebuttable presumption); *In re Hejmowski,* 296 B.R. 645 (Bankr. W.D. N.Y. 2003)(jointly filed bankruptcy); *Loevy Aldrich (In re Aldrich),* 250 B.R. 907 (Bankr. W.D. Tenn. 2000)(The particular circumstances of this case, the court found that the non-filing spouse substantially contributed to the marital home and provided value which resulted in the tax refund; the court noted that wife would have joint liability for any deficiency).

Cf. In re Marble, Ch. 7 Case No. 09-40146 (Bankr. E.D. Mich. Dec. 28, 2009) *rev'd on other grounds,* 2010 U.S. Dist. LEXIS 81881 (E.D. Mich. Aug. 12, 2010). Judge Shapero followed the approach where "a presumption of equal ownership of a joint tax refund exists, but [which] should be limited and may be rebutted by evidence of the spouses' financial history or fiscal practices that demonstrate intentions contrary to equal ownership." *See In re Barrow*, 306 B.R. 28 (Bankr. W.D. N.Y. 2004).

3. Income Prorated Approach:

A third, but not widely utilized approach, is to prorate the amount of income each spouse earned in a given tax year. *In re Hilliou,* 1976 U.S. Dist. LEXIS 15302 (Bankr. E.D. Va. 1976)(non-filing spouse without any income not entitled to any of the tax refund)*; In re Kestner,* 9 B.R. 334 (Bankr. E.D. Va. 1981)(criticized in *McKain); Judson v. Levine (In re Levine),* 50 B.R. 587 (Bankr. S.D. Fla. 1985); *Butz v. Wheeler (In re Wheeler),* 17 B.R. 85 (Bankr. S.D. Ohio 1981).

D. EXEMPT PROPERTY, DISCHARGED DEBT, AND THE RIGHT TO SETOFF.

Creditors or entities in control of estate property which the debtor may exempt under 11 U.S.C. § 522 are required to turn over that property pursuant to 11 U.S.C. § 542(a). Generally, a debtor may exempt property of the estate under § 522; specifically, income tax refunds may be exempted under 11 U.S.C. § 522(d)(5). Additionally, a debtor may avoid a lien, including judicial liens, on assets of the estate under 11 U.S.C. § 522(f) if it impairs the exemption.[6] To the extent that a debtor can demonstrate the availability of an exemption, turnover is required.

This requirement of turnover is balanced with the right to set-off pre-petition debts under 11 U.S.C. § 553(a). The Bankruptcy Code does not create the right of set-off; the Bankruptcy Code simply preserves whatever right to set-off that otherwise exists in state or federal law.[7] For example, non-bankruptcy law allows the offset of any existing tax liability against tax refunds due the tax payer.[8] In meeting 3 criteria for setoff, entities each owing each other money may apply their mutual debts against each other. *Citizens Bank v. Strumpf,* 516 U.S. 16 (1995).[9] Finding that mutuality, one criterion for offset, exists within branches of the federal government, the court in *Maxwell* held that the federal government is considered a single unit and may offset one agency's debt to a

[6] A creditor's right to set off is distinguishable from a creditor's right to levy.

[7] Credit unions have right to set off under Michigan law. *In re Wiegand v. Tahquamenon Area Credit Union*, 199 B.R. 639 (W.D. Mich. 1996).

[8] 26 U.S.C. § 6402(a).

[9] "The right of setoff (also called "offset") allows entities that owe each other money to apply their mutual debts against each other, thereby avoiding 'the absurdity of making A pay B when B owes A.'" *Citizens v. Strupf,* 516 U.S. 16, 18 (1995).

debtor against the debt owed to another agency. *United States v. Maxwell*, 157 F.3d 1099, 1102 (7th Cir. 1998); *In re Bourne*, 262 B.R. 745 (Bankr. E.D. Tenn. 2001).[10]

Courts are divided on the issue of whether a creditor may offset a debt with property that is exempt, recognizing the interplay between § 522(c) with § 553. The majority of courts have concluded that if a tax refund is exempt from the estate, then it is protected from the right of set-off. Property exempted under § 522(c) "is not liable during or after the case for any debt…that arose… before the commencement of the case…." In effect, § 522(c) trumps § 553 and a creditor's right to set-off. This position recognizes the aim to rebuild the debtor through the bankruptcy process, and to permit him/her a fresh start. In *Miel*, the court protected the debtor's right to the exempt tax refund. The IRS was denied the right to set off the general unsecured income tax liability as the debt was not subject to § 523 exceptions, and thus the tax refund was protected under § 522(c). *In re Miel,* 134 B.R. 229 (Bankr. W.D. Mich. 1991); *In re Sharp,* 286 B.R. 627 (Bankr. E.D. Ky. 2002)(Debtors' interest in EITC exempt under state law of Kentucky; to the extent the refund was not exempt, IRS entitled to set off); *But cf. In re Rouse,* 145 B.R. 546 (Bankr. W.D. Mich. 1992)(Court denied debtors' motion for turnover of tax refund as child support liability is non-dischargeable under § 522(a)(5), and therefore was not subject to the debtors' right of exemption pursuant to 11 U.S.C. § 522(c)(1)).

The issue whether discharge bars the creditors right of setoff has also been considered. While Section § 524 bars the post-discharge collection of discharged debt,

[10] *Cf.* 6th Circuit Court affirmed decision to allow offset of pre-petition tax liability with a *post*-petition claim to refund in a chapter 11 as the refund, being used to fulfill terms of the plan, was considered property of the estate . *United States v. Gordon Sel-Way (In re Gordon Sel-Way Inc.),* 270 F.3d 280 (6th Cir. Mich. 2001).

§ 553(a) preserves for the creditor the right to set off after discharge.[11] In a decision rendered by the 5th Circuit, the court held that the debtor's discharge did not affect the IRS' right to set off, relying on the clear statement of § 553 and § 6402 of the Tax Code. The court based also based its decision on the fact that the IRS exercised its discretion to offset the debtor's liability with her overpayment under § 6402(a) and that her liability exceeded her overpayment, therefore, her refund did not become part of the estate. *IRS v. Luongo (In re Luongo),* 259 F.3d 323 (5th Cir. Tex. 2001); *In re Parker*, 2001 Bankr. LEXIS 1488 (Bankr. E.D. Ky. 2001); *Posey v. United States,* 156 B.R. 910 (W.D. N.Y. 1993); *See also Emery v. IRS (In re Emery),* 379 B.R. 688 (Bankr. W.D. Ky. 2007)(court allowed setoff of discharged debt even when asset exempt); *In re Eggemeyer*, 75 B.R. 20 (Bankr. S.D. Ill. 1987).

[11] 11 U.S.C. § 553(a) provides: "except as otherwise provided in this section and in sections 362 and 363 of this title, this title does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title. . . ."

7TH ANNUAL CONSUMER BANKRUPTCY CONFERENCE

AMERICAN BANKRUPTCY INSTITUTE

DETROIT, MICHIGAN
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LIFE INSURANCE EXEMPTION ISSUES

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LIFE INSURANCE EXEMPTION ISSUES

I. LIFE INSURANCE CONTRACTS

A life insurance policy is a contract between a policy holder, or owner, and an insurer, wherein the insurer agrees to pay a designated beneficiary a particular sum of money upon the death of the insured person. The types of life insurance contracts are varied, and it is important to understand which type of contract the Debtor has, as well as what role the Debtor plays with respect to the contract.

In life insurance contracts there are four roles: The insurer, the policy owner, the insured individual, and the beneficiary. The owner is typically the person who procures the policy and pays the premiums. The insured is the person upon whose life the policy is based, and upon whose death the benefits will be paid. The insured is a participant in the contract but is not necessarily a party to it. The beneficiary receives policy proceeds upon the insured's death. The owner designates the beneficiary, but the beneficiary is not a party to the policy. The owner can change the beneficiary unless the policy has an irrevocable beneficiary designation. With an irrevocable beneficiary, that beneficiary must agree to any beneficiary changes, policy assignments, or cash value borrowing.

The distinction between the roles can be critical, and technically, the owner and the insured roles can be filled by the same person. In cases where the policy owner is not the insured, an “insurable interest” is generally required, The "insurable interest" requirement usually demonstrates that the purchaser will actually suffer some kind of loss if the insured dies. Close family members and business partners will usually be found to have an insurable interest. Such a requirement prevents people from benefitting from the purchase of purely speculative

policies on people they expect to die, and limits opportunities for fraud or even murder. In contrast, although the owner is typically the person who pays the premiums, most insurers do allow the payor and the owner to be different parties; for example, a parent paying premiums for a policy owned by a grandchild, where the insured is the parent of the grandchild.

Although there are numerous different types of policies, for bankruptcy purposes, there are two main categories: Term Insurance and Permanent Insurance. Term insurance extends for a particular term or number of years, and the only way any funds are generated by the policy is if the insured dies before term expires. Term insurance policies do not have any cash value; the premium buys coverage in the event of death and nothing else.

Non-term, or permanent, insurance policies remain in force until the policy matures (pays out upon the death of the insured), assuming all premiums are paid when they are due. Over time, as premiums are paid and the risk to the insurer is reduced, the policy builds a cash value that can be accessed by the owner by withdrawing it, borrowing it, or surrendering the policy. The cash values developed by whole life policies typically include two components:

- A guaranteed cash value, which increases based on a pre-determined schedule during the life of the policy and which "endows" or equals the death benefit upon maturity of the policy (typically at age 100).

- Also, most life policies have a non-guaranteed cash value component which may arise from dividends or interest over time.

It is important to note that the cash value components of life insurance policies co-exist with, and are separate and distinct from, the beneficiary's expectancy of the death benefit. Cash values are generally kept by the insurance company at the time of death, and only the death benefit is paid to the beneficiary.

Not surprisingly, there are different types of permanent policies; two common types are

whole life and universal life. Whole life insurance is designed to remain in effect throughout the insured's life and is well suited to objectives that do not diminish over time, such as paying the costs of settling the insured's estate and taxes. The premium typically stays the same throughout the life of the policy. Universal life insurance policies are more flexible than whole life, by allowing the policy owner to modify the premium or the benefits in the event of changing needs and circumstances. By allowing for increases in premiums, universal life policies may not have pre-established cash values, and have potential for greater growth of cash values. Such permanent policies are often viewed as investment policies with the objective of growing capital.

II. EXEMPTION OF LIFE INSURANCE WITH FEDERAL EXEMPTIONS

For Debtors who opt to use the federal exemptions pursuant to 11 USC 522(b)(2), Section 522(d) provides three separate exemptions that relate to life insurance policies, depending on the type of role the Debtor has with respect to the subject policy. As noted above, a Debtor may have more than one interest in the same policy, and most courts view the Debtor's interest as an owner as distinct from the Debtor's interest as a beneficiary under the policy.

A. 11 USC 522(d)(7). Section 522(d)(7) protects "any unmatured life insurance contract owned by the debtor, other than a credit life insurance contract." This exemption refers to the life insurance contract itself and does not encompass any other rights under the contract, such as the right to borrow the loan value. The exemption is included in the Bankruptcy Code to prevent trustees from surrendering policies in which the Debtor is both the owner and the insured, causing policies to lapse to the detriment of potential beneficiaries.

Recently, in *In re Schoof* in the Eastern District of Michigan, the court reiterated the principle that the exemption is for the contract itself and nothing more, stating "All that is exempted by 522(d)(7) ... is the life insurance policy itself, and not a debtor's rights under the policy ... If a debtor wishes to protect dividends or interest that have accrued under a policy, such as a policy's cash surrender value, he or she must claim exemption in that interest under 522(d)(8)." (Opinion in *In re Schoof* dated March 24, 2011 in Case No. 10-60887, E.D. Mich., citing *In re Steiner*, 2010 WL 4687955 (Bankr. D. Idaho Nov. 10, 2010). The *Shoof* Court referred back to the legislative history of Sec. 522(d)(7), noting the exemption "refers to the life insurance contract itself. It does not encompass any other rights under the contract, such as the right to borrow out the loan value. Because of this provision, the trustee may not surrender a life insurance contract, which remains property of the estate if he chooses Federal exemptions H.R.Rep. No 595, 95th Cong., 1st Sess, 361, reprinted in 1978 U.S.C.C.A.N. 5787, 5963, 6317."

B. 11 USC 522(d)(8). Section 522(d)(8) exempts up to $11,525 of the cash value of an unmatured life insurance contract owned by the debtor, under which the debtor or an individual on whom the debtor depends is the insured. The exemption specifically includes the second component of cash value - accrued dividends and interest. The limitation on the dollar amount of the exemption is subject to adjustment at 3-year intervals to reflect changes in the Consumer Price Index, the most recent adjustments being effective as of April 1, 2010.

In *In re Swartz*, 18 B.R. 454 (D. Mass. 1982), the Court again looked to the congressional intent underlying Section 522(d)(8). By utilizing this exemption, a Debtor has the ability to keep **one** policy in force, without paying over its cash value. This allows the Debtor to preserve

an existing policy in the event that he might have difficulty obtaining another, due to age or any health issues that may have arisen subsequent to the acquisition of the original policy. Further, the exemption is to be read in the singular, and is not intended to create an exemption in each and every policy in effect at the time of the filing.

In *In re Zerbi*, 2011 WL 175923 (Bankr. W.D.Mich. 2011), the debtor claimed the cash value of his life insurance policy as exempt under §522(d)(8) (at which time the applicable value limitation was $10,775), and under §522(d)(7), which does not include a dollar limitation. The court determined that §§522(d)(7) and (d)(8) address different aspects of life insurance policies, and the court must give meaning to both subsections. §522(d)(7) exempts the policy itself, while §522 (d)(8) exempts the debtor's rights under the policy, including accrued dividends and cash surrender value. The Court then calculated the non-exempt portion of the cash value at and ordered that the policy would be surrendered if the debtor was not able to pay the non-exempt portion to the trustee. The Court pointed out that ". . . if, however, he cannot satisfy the Trustee's claim to the Cash Value without surrendering the Policy, the court, on motion, will require surrender. This was the practice under the Bankruptcy Act, and Congress did not intend to depart from that practice by enacting Sec. 522(d)(7), except as expressly set forth in Sec. 522(d)(8)."

C. 11 USC 522(d)(11)(c). Section 522(d)(11)(C) exempts the right to receive a payment as a beneficiary under a life insurance contract, or property traceable to such a right. The ability to "trace" preserves the right to the exemption even if the property changes form - for example, from a right to receive to a check, an account, or actual cash proceeds.

The exemption is limited to the extent that the proceeds are reasonably necessary for the

support of the debtor or a dependent of the debtor, and the debtor must have been a dependent of the insured. In instances where the debtor is a beneficiary claiming to be a dependent of the insured, the debtor's dependency is determined as of the date of the insured's death.

While property of the bankruptcy estate generally includes that which exists on the date of the bankruptcy filing, Bankruptcy Code § 541(a)(5)(C) brings into the estate property acquired, or which the debtor becomes entitled to acquire, within 180 days after the filing as a beneficiary of a life insurance policy. A debtor who is a named beneficiary under a policy which matures within 180 days of the bankruptcy filing must file a supplemental schedule disclosing the subsequently acquired interest. Bankruptcy Rule 1007(h). The right to receive the insurance proceeds, or the proceeds themselves, are property of the estate as if they were acquired prior to the bankruptcy filing, and as such, may also be exempted under 522(d)(11)(C).

III. EXEMPTION OF LIFE INSURANCE WITH STATE EXEMPTIONS

If a Debtor chooses not to avail himself of the federal exemption scheme provided by 11 USC 522(b)(2) and 522(d), under §522(b)(3) he or she may protect property which is exempt under state law exemption statutes. There is no bankruptcy-specific exemption under Michigan law at either MCL 600.6023 or at MCL 600.5451 which is applicable to life insurance policies.

Michigan law and public policy clearly protects families by providing exemptions for beneficiaries of life insurance policies, from both the claims of creditors of the insured (MCL 500.2207) and creditors of the beneficiary (MCL 500.4054). "In regards to life insurance contracts, the general public policy is to protect the insurance taken out by a person for the maintenance and support of the person's spouse and children from the claims of creditors after

the person's death." *Baltrusaitis v. Cook*, 174 Mich. App. 180 (1988) citing *Equitable Life Assurance Society of the United States v. Hitchcock*, 270 Mich. 72 (1935). In *In re Parsons*, 161 B.R. 194 (Bankr. W.D. Mich. 1993), the court noted that both MCL 500.2207 and MCL 500.4054 contain language protecting insurance proceeds payable to a beneficiary other than the insured, stating that in order to exempt insurance proceeds, limited circumstances must be present, and chief among those is that the beneficiary or payee is distinct from the insured. Reiterating the public policy, the court stated that the exemption provisions are focused on the protection of third parties who benefit from insurance contracts, from the creditors of the insured.

With regard to cash values of life insurance policies prior to the maturity of the policy, many states provide nearly unlimited exemptions. Debtors domiciled in Michigan who opt to use state exemptions may cite the exemption at MCL 500.2207 within the Michigan Insurance Code to protect the proceeds or cash value of a policy owned by the Debtor. The statute states in subparagraph (1) that when a husband insures his own life for the benefit of his wife or children, the money which becomes payable under the insurance is "payable to the person or persons for whose benefit the insurance was procured ... free from all claims of the representatives of such husband or father, or of any of his creditors ...". It would seem apparent based upon a reading of this section, that the intent of the statute is to protect beneficiaries of the policy from creditors of the owner and the insured.

Reading further in subparagraph (1), "the proceeds of any policy ... which is payable to the [beneficiary], including the cash value thereof, shall be exempt from execution or liability to any creditor of the insured." The specific reference to cash value is often pointed to by Debtors to suggest that his or her exemption in the cash value is, indeed, protected for the Debtor's benefit. As noted, however, the statute as a whole is intended to protect the

beneficiary, not the Debtor where he or she is the insured. A Trustee or creditor advocating the view that MCL 500.2207 does not exempt the cash value of a policy from the insured's creditors may point to a number of Michigan cases wherein creditors were allowed to garnish the cash value of a life insurance policy, where the Debtor was the owner or insured. In the matter of *Chrysler First Business Credit Corporation v. Rotenberg v. John Hancock Mutual Life Insurance Company,* 789 F Supp 870 (WD Mich 1992), the federal District court decided that the cash value was indeed accessible to a creditor. However, it should be noted that MCL 500.2207 did not appear to be at issue in the dispute; rather, the Court looked to Michigan's garnishment statute and court rules in support of its holding. See also *Schenck Boncher & Prasher v. Vanderlaan*, 2003 Mich. App. Lexis 2082 (2003), in which the Michigan Court of Appeals found that surrender values of insurance policies are non-exempt personal property subject to being applied to satisfy a judgment. Again, however, MCL 500.2207 was not raised as an exemption nor discussed in the opinion.

In contrast, a number of courts have upheld exemptions of cash values under MCL 500.2207. In *In re Johnson*, 274 B.R. 473 (Bankr. E.D. Mich. 2002), the court agreed with the Debtor in finding that the statute specifically exempts the cash surrender value of a husband's life insurance policy which lists his wife as beneficiary. In other cases upholding such an exemption, discussion of the actual text and intent of the statute is perplexingly absent. *In re Sassak*, 426 B.R. 680 (E.D. Mich. 2010). These cases do not distinguish between the cash value of a policy payable to an owner during his life, and the cash value component of a policy which continues to exist after the insured's death.

IV. NON-EXEMPT LIFE INSURANCE POLICIES AND PROCEEDS

The ability to exempt a life insurance policy and any cash value bears upon the trustee's ability to liquidate those assets for the benefit of the bankruptcy estate. In addition, in a non-individual case where exemptions are not in play, the ability of the trustee to turn a policy into cash should be noted.

Certain policies carry a cash surrender value. In a business setting, they are often known as "key person policies". If the bankruptcy estate is the owner of the policy, those policies can be surrendered to the life insurance company for the cash surrender value. Alternatively, trustees will determine whether policies can be sold by the bankruptcy estate to institutional investors, such as insurance companies, banks, pension funds, and hedge funds. Buyers make these decisions based upon investment decisions–what's the life expectancy of the beneficiaries, and how much are they paying for the policy. In this situation, buyers of the policies will keep the policies in place, continue to pay the premiums and ultimately receive the death benefits upon the death of the beneficiaries.

Similarly, most term policies carry a conversion feature whereupon a certain length of time a policy is in place, or age of insured, the owner may convert the policy from a term policy to a permanent policy. A buyer of "life settlements" will purchase not only policies with cash surrender values, but also term policies with this conversion feature if they believe they can achieve their desired return on investment. A good rule-of-thumb is that if the death benefit is $500,000 or more, and the age of the beneficiary is 70 or greater, a trustee may want to review a term policy for conversion to a permanent policy.

In an individual case where exemptions come into play, a debtor would be able to exempt the policy itself under Section 522(d)(7) of the Bankruptcy Code to prevent the trustee from selling the policy. However, if an individual debtor has a change of need and, for instance,

can't afford to make premium payments into the future, or no longer has a beneficiary he or she wishes to protect, the trustee may want to explore a "deal" with the debtor to allow the sale of the policy as a life settlement whereby both the estate and the debtor may be able to turn the policy into cash.

A practical issue arises in that a buyer of a life settlement would want to determine the life expectancy of the debtor, and the debtor would need to cooperate with respect to his or her medical history and records. See *In Re Adam Aircraft Industries, Inc*., 422 BR 263 (Bankr. Colo.2009), where the Court protected the debtor from the trustee and life settlement company, which was attempting to force the debtor to disclose medical records.

ADVANCED CHAPTER 7 TRACK: PART 2
INSIDER PREFERENCES
OUTLINE

1. Preference is a prepetition transfer in which a creditor is preferred at the expense of other creditors in the bankruptcy. A Trustee, pursuant to 11 USC 547(b) may avoid that transfer if certain conditions are met including the fact that the transfer was within 90 days of the filing of the petition.
2. Insider preference extends the 90 days to one year
3. Who is an insider
   a) not defined
   b) fact specific
   c) different definition for individual and corporations
4. 11 USC 101(31) provides examples. The term includes individual, corporation, partnership, municipality.
5. 11 USC 101(45) defines relative
6. In Re Harvey Goldman, Judge Shefferly's case with Stuart Gold as the Trustee is the answer
7. Other "cousins"
   Sufficiently close relationship with the debtor that his conduct is made subject to closer scrutiny than those dealing at arm's length with the debtor.
8. Practice points
   Insider as guarantor

ADVANCED CHAPTER 7 TRACK: PART 2
INSIDER PREFERENCES

Homer W. McClarty
Chapter 7 Trustee
November 11, 2011

Recent developments and issues in the determination of "insider" status as it pertains to individual debtors for purposes of applying the preference rule in 11 U.S.C. § 547(b)(4)(B).

DISCUSSION OF AUTHORITY

I. Application Of The "Insider" Rule

The so-called "insider rule" applied within the context of the United States Bankruptcy Code preference rule seems simple enough. The important and substantive preferential transfer powers given to trustees are set forth in 11 U.S.C. § 547(b). Under that provision, a trustee may avoid a prepetition transfer in which a creditor is "preferred" at the expense of other creditors in the bankruptcy. *In re Eckman*, 447 B.R. 546, 548 (Bankr. N.D. Ohio 2010) ("Preferences are treated with disfavor in bankruptcy because they contradict the fundamental bankruptcy policy of ensuring the equitable distribution of a debtor's nonexempt assets among similarly situated creditors.").

The trustee has the authority to reach back to certain transactions made by the debtor prior to filing for bankruptcy protection and recover the debtor's property for

purposes of distribution through the bankruptcy estate. To avoid a prepetition transfer, however, the trustee must establish six elements: (1) there must be a transfer of the debtor's property; (2) to or for the benefit of a creditor; (3) for or on account of an antecedent debt; (4) while the debtor was insolvent; (5) within 90 days preceding the petition; and (6) which transfer allows the receiving creditor to get a greater percentage of its claim than the creditor would have received had the transfer not been made and had the debtor filed under Chapter 7. *See* 11 U.S.C. § 547(b).

The insider rule extends the 90-day prepetition preference transfer period to a period of one year, where the receiving creditor has a special relationship with the debtor so as to qualify as an "insider." The Bankruptcy Code, however, fails to provide a specific definition of who qualifies as an "insider." Instead, "[t]he word 'insider' is a term of art under the Bankruptcy Code." Robert E. Ginsberg et al., *Ginsberg & Martin on Bankruptcy* § 8.02, at 8-35 (2011). While the insider rule generally includes most people that have a close blood, financial, or control relationship with the debtor, the actual application of the rule to a specific individual is extremely fact-specific. *Id.*

The Bankruptcy Code also refers to "insiders" of an individual debtor differently from the "insider" of a corporate debtor. These materials explore the factors courts apply to determine which creditors qualify as having a prepetition insider relationship with an individual debtor. Section 547(b)(4)(B) only states that the extended timing of a possible preferential transfer is "between ninety days and one year before the date of the filing of a

petition, if such creditor at the time of such transfer was an insider."[1] The definition section of the Bankruptcy Code, 11 U.S.C. § 101(31), provides examples of relationships "included" in the scope of the insider term. Specifically, under § 11 U.S.C. 101(31)(A) "if the debtor is an individual," the term "insider" *includes*: "(i) relative of the debtor . . . ; (ii) partnership in which the debtor is a general partner; (iii) general partner of the debtor; or (iv) corporation of which the debtor is a director, officer, or person in control."

II. Persons Included As Insider "Relatives" Of The Debtor

Under § 101(45), the Bankruptcy Code defines the term "relative," which is an important component of the § 101(31) individual-debtor insider rule, as an "individual related by affinity or consanguinity within the third degree as determined by the common law, or individual in a step or adoptive relationship within such third degree."[2] 11 U.S.C. § 101(45). Under this definition, courts may only look to the common law when determining if a particular individual qualifies as a relative. Yet, even the term "common

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[1]"Insiders" also play a important role under the fraudulent transfer rule, 11 U.S.C. § 548. *See* 11 U.S.C. § 548(a)(1)(B)(ii)(IV) ("The trustee may avoid any transfer . . . of an interest of the debtor in property . . . if the debtor voluntarily or involuntarily . . .made such transfer to or for the benefit of an insider, or incurred such obligation to or for the benefit of an insider, under an employment contract and not in the ordinary course of business.").

[2]"Affinity" is defined in *Black's Law Dictionary* (9th ed. 2009), as: "The relation that one spouse has to the blood relatives of the other spouse; relationship by marriage; [or] Any familial relation resulting from a marriage." "Consanguity" is defined as; "The relationship of persons of the same blood or origin."

law" is interpreted differently between bankruptcy courts. Some courts look to the civil law referred to in the Code, while others look to the canon law as the common law referred to in the Code. Which "common law" is chosen will make a substantial difference in whether an individual qualifies as a relative insider for purposes of a § 547(b) preferential transfer.

In *In re Harvey Goldman & Co.*, 2011 WL 3734912 (Bankr. E.D. Mich. 2011), the Michigan bankruptcy court (Judge Phillip Shefferly) meticulously presented the issues which arise when a court is asked to review whether an individual creditor is a "relative" of the debtor under the insider rule. Specifically, the court was asked to determine whether Yitzchok Rubin, who received a payment from the debtor more than 90 days but within one year before the bankruptcy petition, was an insider. Rubin was David Simcha's second cousin, and Simcha served as the president of the debtor corporation. Without any guidance from the Sixth Circuit as to how to evaluate insider status, the Michigan bankruptcy court narrowed its analysis as to what the Code meant by the phrase "common law" in the relative definition at § 101(45), and whether the common law determines if Rubin, as Simcha's second cousin, is within the third degree of consanguinity to be an insider.

The *Harvey Goldman* court examined the two common law methods of determining one's relationship to another. Under the "civil law" method, the degrees of generations are determined by counting up by generations "starting with either of the two

descendants up to the common ancestor, and then the counting descends from the common ancestor back down to the other descendant who is alleged to be a relative." *Id.* at *4. By contrast, the degrees of generations under the "canon law" are determined simply by counting from the common ancestor down to the farthest of the two descendants whose degree of relationship is at issue. *Id.*

In ultimately deciding to apply the civil law method, the bankruptcy court in *Harvey Goldman* looked to state law and how consanguinity is determined under Michigan common law. *See Van Cleve v. Van Fossen*, 73 Mich. 342, 41 N.W. 258, 259 (1889) (consanguinity for purposes of inheritance issues is determined by civil law methods); *see also State ex rel. Weiss v. Feldman*, 28 Ohio L. Abs. 104, 1938 WL 6744 (Ct. App. 1938) (applying the civil law for computing degrees of kinship); *Ga. Power Co. v. Watts*, 184 Ga. 135, 190 S.E. 654 (1937) (calculating degrees of relationships using the civil law method). Applying the consanguinity formula under the civil law, the court in *Harvey Goldman* held that the relationship between Rubin and Simcha represented six degrees of consanguinity, and therefore Rubin was not considered a relative of Simcha under § 101(45).

While there are few judicial decisions on point, the court in *Harvey Goldman* discusses that some states, including Missouri, apply the canon law method of determining degrees of generation. In *In re Gray*, 355 B.R. 777 (Bankr. W.D. Mo. 2006), the court held that the canon law method for determining insider status is more consistent

with the purpose of § 547 and will equalize the distribution scheme among similarly situated creditors. *See also In re Cloverleaf Farmer's Co-Operative*, 114 B.R. 1010 (Bankr. D.S.D. 1990), *cited in Gray*, 355 B.R. at 782 (n.23) and also holding that the canon law method brings in more creditors into the insider rule). Under the canon law method, the relationship between Rubin and Simcha would have fallen within the three degrees of consanguinity required for a relative under § 101(45), and would have allowed a preferential transfer under the insider trader rule.

III. Other Nonfamilial Individuals Who May Qualify As Nonstatutory Insiders

In addition to determining whether a particular individual is a relative of the debtor for purposes of meeting the insider status under the preference rule, courts also closely scrutinize the relationships between nonfamily individuals to determine whether the insider status may be conferred on a creditor. Again, the determination of whether the personal relationship between the debtor and a creditor constitutes "insider" status is intensely fact-based. *In re Tompkins*, 430 B.R. 453 (Bankr. W.D. Mich. 2010). Because "insider" is defined using the word "includes," if the relationship between the debtor and the creditor is not included in the list of examples in the Code, the court may still conclude that an insider relationship exists.

In determining whether a nonstatutory relationship rises to the level of an insider, the court will look at the relationship between the debtor and the creditor as of the time of

the transfer. *See In re Hollar*, 100 B.R. 892 (Bankr. N.D. Ohio 1989). In *In re Piccinini*, 439 B.R. 100 (E.D. Mich. 2010), in the absence of guidance from the Sixth Circuit Court of Appeals on nonstatutory insider status, the court looked to the Third Circuit for standards to apply. Specifically, the court held:

> The Sixth Circuit case law on non-statutory insider status is scarce, and the court must consider case law decided outside this district and circuit. Most recently, the Third Circuit in *In re Winstar Communications, Inc.,* 554 F.3d 382 (3rd Cir.2009) elaborated on the standard for determining whether a creditor may be treated as a "non-statutory insider." A showing of actual control over the debtor is not necessary; instead, the court asks "whether there is a close relationship [between debtor and creditor] and . . . anything other than closeness to suggest that any transactions were not conducted at arm's length." *Id.* at 396–97 (citations omitted); *see also* S.Rep. No. 95–989, at 25 (1978), as reprinted in 1978 U.S.C.C.A.N. 5787, 5810 ("An insider is one who has a sufficiently close relationship with the debtor that his conduct is made subject to closer scrutiny than those dealing at [arm's] length with the debtor.") Arm's length is traditionally defined as any transaction negotiated in good faith in the ordinary course of business by parties, each with independent interests and acting in their own best interests. *In re U.S. Medical, Inc.,* 531 F.3d at 1277, n. 4.

Id. at 104; *see also In re Grove-Merritt*, 406 B.R. 778, 800 (Bankr. S.D. Ohio 2009) ("[T]he crux of determining whether a person is an insider under the Code is ferreting out whether that person has a sufficiently close relationship with the Debtor that his conduct is made subject to closer scrutiny than those dealing at arm's length with the debtor, including determining the extent to which the defendant was in a position to control or influence the debtor." (internal quotation marks omitted)); *see also In re Reilly*, 2007 WL 4731020 (Bankr. M.D. Fla. 2007); *In re Lopriesti*, 2007 WL 2708605 (Bankr. D.N.J. 2007).

In *In re Tompkins*, the Michigan court acknowledged that the so-called nonstatutory insider status may arise even where the individual debtor and creditor are no longer related, but yet continue to have a close relationship so as to subject them to strict scrutiny. The court stated:

> Even assuming, *arguendo,* that the Petries were not insiders related by affinity, the court nevertheless concludes that their relationship at the time of the Transfer was not an "arms length" relationship, given the familial ties between the Petries, their daughter, and their grandchildren—ties that survived the divorce. As noted above, the Bankruptcy Code definition of "insider" is flexible, and takes into account a variety of relationships that call for closer scrutiny, beyond the specifically enumerated insider relationships . . . [A]s noted above, the making of the loan to the Debtor and Ms. Petrie, and the subsequent forgiveness of that debt in exchange for the Transfer, were quintessentially family transactions, given the close relationships involved and the degree of control the Petries exercised over their daughter and the Debtor as their principal benefactor and creditor.

430 B.R. at 460.

Similarly, in *Piccinini*, consistent with the decisions discussed above, the court held that a trustee need not establish a creditor's actual control over a debtor to qualify that creditor as a nonstatutory insider. Instead, where there is a showing of a close relationship between the debtor and the creditor and evidence that the transaction was not at arm's length, the creditor may be considered an insider for preferential transfer purposes.

Even with the flexible approach taken by the courts in determining whether nonfamilial relationships between a creditor/transferee and the debtor/transferor qualifies the creditor as "insider," courts generally agree that friendship alone is not enough to

render someone an insider. *In re Greenwood Point, LP*, 445 B.R. 885 (Bankr. S.D. Ind. 2011); *see also In re Phongsavath*, 328 B.R. 895 (Bankr. N.D. Ga. 2005); *Reilly*, 2007 WL 4731020, at *3. Yet, if the relationship is analogous to a family one, the insider relationship may exist. *Phongsavath*, at 898. In *In re Dupuis*, 265 B.R. 878 (Bankr. N.D. Ohio 2001), the court held that the debtor and his ex-spouse may be insiders if the two continued to maintain a close business relationship and continued to combine certain marital assets. This may also arise when the debtor and creditor cohabitate for years and the debtor relies on the other for financial support or other things. *See In re Levy*, 185 B.R. 378 (Bankr. S.D. Fla. 1995) (holding that the debtor's girlfriend, with whom he lived for five years, was an insider); *In re Tanner*, 145 B.R. 672 (Bankr. W.D. Wash. 1992) (holding that cotenancy by itself is not enough to conclude the cotenant is an insider, but where the facts demonstrated the cotenant's influence over the debtor, the cotenant was considered an insider).

IV. Indirect Guarantor Insider Issues

The court's treatment of guarantor insiders, who are only indirectly benefitted from a transfer, is another insider issue which is intensely fact-specific.[3] This issue is illustrated in the recent decision, *In re Halley*, 449 B.R. 911 (W.D. Wis. 2011). In that case, the debtor borrowed $45,000 from a bank which loan was guaranteed by her son. The bank took a mortgage on the mortgagor/son's home to secure the loan to the mother. The debtor made monthly payments to the bank for one year prior to filing for bankruptcy protection. The trustee sought to transfer the year's worth of payments, equaling $4,100, under the insider preference rule, even though it was the noninsider bank that directly benefitted from the transfer, not the insider son.

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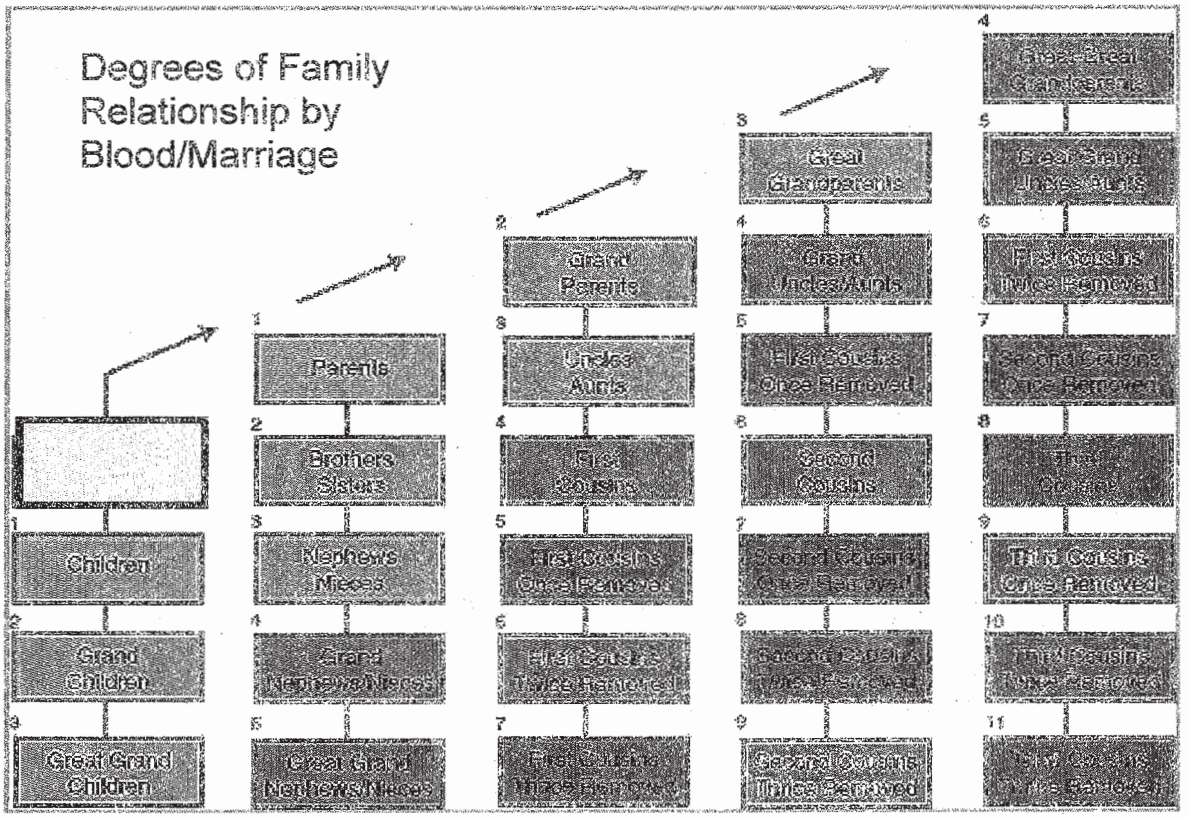
[3]It is important to acknowledge that under 11 U.S.C. § 101(34) the corporate insider definition is more specific but it, too, is defined by "example" and the court has broad discretionary authority to determine whether a nonstatutory creditor (i.e a creditor who is not a director, officer or general partner) of the debtor is an insider for preferential transfer purposes. *See In re S. Beach Sec., Inc.*, 376 B.R. 881, 889 (Bankr. N.D. Ill. 2007), (the insider does not have to have a legal relationship or absolute control over the debtor to be considered an insider), *aff'd*, 421 B.R. 456 (N.D. Ill. 2009). *But see In re ABC Elec. Serv. Inc.*, 190 B.R. 672 (Bankr. N.D. Fla. 1995) (where a creditor has the potential to exercise control over the debtor but never applies that potential, the facts may not warrant the insider determination).

Citing *In re Deprizio*, 874 F.2d 1186 (7th Cir. 1989),[4] the bankruptcy court in *Halley* held that the son was a creditor under the Code because, in the absence of any waiver in the guaranty, the son had a contingent right to payment from his mother, and thus was the holder of a "claim" under § 101(5)(A) at the time of the bankruptcy filing. Therefore, "[the mother's] payments to the bank were for his benefit because each reduction in the debt reduced his possible exposure to the bank." *Halley*, 449 B.R. at 916. The court further held that the trustee could avoid the transfer from either the bank or the transfer beneficiary under § 550(a)(1). *Id.*; *see also In re M2Direct, Inc.*, 282 B.R. 60 (Bankr. N.D. Ga. 2002) (holding that an insider guarantor may be liable for preferential transfers made by the debtor to lenders).

[4]*Deprizio* was partially overruled when Congress added § 547(ii) to the Bankruptcy Code in 2005. This section provided that preference claims against noninsiders were limited to the 90-day period. The amendment, however, did not preclude the trustee from recovering from a guarantor insider under the longer preference period even if the trustee could not recover from the bank. Title 11 U.S.C. § 550(c) also does not protect insider guarantors from a preference claim.

EXHIBIT 1

Consanguinity/Affinity Chart



INSTRUCTION:

For Consanguinity (relationship by blood) calculations:

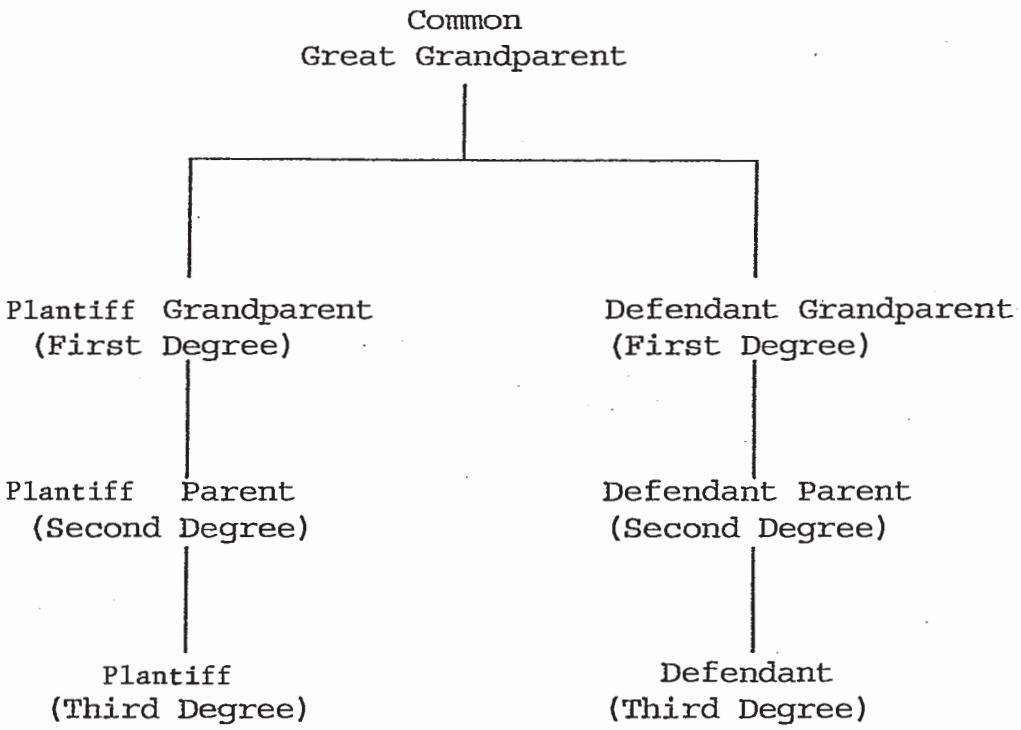
Place the public officer/employee for whom you need to establish relationships by consanguinity in the blank box. The labeled boxes will then list the relationship by title to the public officer/ employee and the degree of distance from the public officer/employee.

Anyone in a box numbered 1, 2, or 3 is within the third degree of consanguinity. Nevada Ethics in Government Law addresses consanguinity within the third degree by blood, adoption, or marriage.

For Affinity (relationship by marriage) calculations:

Place the spouse of the public officer/employee for whom you need to establish relationships by affinity in the blank box. The labeled boxes will then list the relationship by title to the spouse and the degree of distance from the public officer/employee by affinity.

A husband and wife are related in the first degree by marriage. For other relationships by marriage, the degree of relationship *is the same as the degree of underlying relationship by blood*,


Common
Great Grandparent
Plantiff Grandparent
(First Degree)
Defendant Grandparent
(First Degree)
Plantiff Parent
(Second Degree)
Defendant Parent
(Second Degree)
Plantiff
(Third Degree)
Defendant
(Third Degree)