Retirement Planning and Bankruptcy

CONCURRENT SESSION

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Select Issues Related to the Intersection of Retirement Planning and Bankruptcy

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I. How much is too much? Considering voluntary retirement contributions and retirement plan loan repayments in light of the "abuse" standard of 11 USC 707(b)(3).

In an age where company funded pension plans are becoming more and more scarce, 401(k) plans and similar voluntary, self-funded, tax favored retirement plans are a necessity for any individual looking to provide security in his or her retirement years. When an individual seeks bankruptcy protection, the question becomes: How much can a Chapter 7 debtor contribute to a voluntary retirement plan or pay back toward a retirement plan loan and still avoid scrutiny and potential dismissal pursuant to the relaxed "abuse" (vs. "substantial abuse" pursuant to pre-BAPCPA law) standard of 11 USC 707(b)(3)? Creditors and the United States Trustee frequently argue that voluntary retirement contributions and retirement plan loan repayments at the expense of creditors (i.e., while simultaneously discharging debt) is unnecessary, unreasonable, inappropriate and warrants dismissal or conversion of a Chapter 7 case. Debtors take the position that voluntary retirement contributions are a reasonable and necessary expense given the lack of company funded pensions and limited nature of Social Security benefits. In other words, debtors argue that voluntary contributions are "mandatory" in today's climate.

A. 11 USC 707(b)(3)(B) – "Totality of Circumstances"

Courts considering the issue of the amount and appropriateness of voluntary retirement contributions and retirement plan loan repayments for Chapter 7 debtors have done so, generally, in the context of a motion to dismiss by an interested party (generally the US Trustee) pursuant to 11 USC 707(b)(3). When adjudicating a motion to dismiss pursuant to 11 USC 707(b)(3), the Code directs the Court to consider whether "the totality of the

circumstances. . . of the debtor's financial demonstrates abuse." Sixth Circuit cases examining the "totality of circumstances" test include *In re Krohn*, 886 F.2d 123 (6th Cir. 1989) and *Behlke v. Eisen* (*In re Behlke*), 358 F.3d 429 (6th Cir. 2004). In considering the totality of circumstances, these courts evaluated whether a debtor displays a lack of honesty or a want of need, either of which providing a justification for dismissal. *Krohn*, 886 F.2d at 126; *Behlke*, 358 F.3d at 434. Whether a debtor is sufficiently needy to justify Chapter 7 relief involves an evaluation of several equitable factors. One of the key factors and perhaps the factor most relevant when evaluating the amount and appropriateness of voluntary retirement contributions is whether a debtor has an ability to repay his creditors from future earnings. *Krohn, supra* at 126. A debtor's ability to repay his creditors is typically evaluated in light of whether a debtor has sufficient disposable income to fund a hypothetical Chapter 13 Plan. *Belke, supra* at 435. Other factors include "whether the debtor enjoys a stable source of future income, whether he is eligible for adjustment of his debts through Chapter 13 of the Bankruptcy Code, whether there are state remedies with the potential to ease his financial predicament, the degree of relief obtainable through private negotiations, and whether his expenses can be reduced significantly without depriving him of adequate food, clothing, shelter and other necessities." *Krohn, supra* at 126 – 127. As discussed below, while a debtor's ability to repay his creditors from future earnings may be a dispositive factor in certain circumstances, 6th Circuit precedent requires a court to consider the factors set forth in *Krohn*. *See In re Moutousis,* 418 B.R. 703 (Bankr. E.D. Mich. 2009) ("A better reading of *Krohn* is that the ability of the debtor to repay his debts out of future earnings may be the dispositive factor, but it does not permit the bankruptcy court to fail to consider the other *Krohn* factors in determining whether the petition is abusive under the

totality of the circumstances. . . At a minimum, this would require the bankruptcy court to permit the debtors the opportunity to present evidence concerning the factors the *Krohn* court articulated as relevant to the question of whether the debtors can be considered 'needy'" *Id*. at 709 – 710.)

B. Disposable Income – Ability to Repay Creditors – Hypothetical Chapter 13 Plan

The Sixth Circuit in *Behlke* found that in certain situations a debtor's ability to pay can be determinative in the totality of circumstances evaluation ("the ability to pay may be. . . sufficient to warrant dismissal"). *Behlke, supra* at 434-35. Courts will often engage in an analysis of a hypothetical Chapter 13 Plan pursuant to the debtor's circumstances to evaluate the debtor's ability to pay. Evaluating a hypothetical Chapter 13 Plan and the likely dividend to creditors centers on a debtor's "disposable income." "Disposable income" is defined under the Bankruptcy Code as income received by the debtor which is not reasonably necessary for "the maintenance or support of the debtor or a dependent of the debtor." 11 U.S.C. §1325(b)(2)(A)(i).

Whether a retirement contribution or loan repayment is reasonably necessary for the support of the debtor in any given case is a fact-specific inquiry to be evaluated on a case-by-case basis. *E.g., In re Beckerman,* 381 B.R. 841 (Bankr. E.D. Mich. 2008), *see also, In re Zaporski*, 366 B.R. 758, 770-71 (Bankr. E.D. Mich. 2007). Courts take into account factors such as "(1) amount of any existing retirement savings; (2) the debtor's age and time left until retirement; (3) annual income and overall budget; (4) amount of monthly contributions; and (5) needs of any dependents" in determining whether voluntary retirement contributions or loan repayments are properly excludable from disposable income. *In re Beckerman,* 381 B.R. at 848. In general, the younger the debtor and the more retirement savings the debtor

has, the more likely a court would consider voluntary retirement contributions as disposable income in a hypothetical Chapter 13.

C. Recent Applicable Case Law

1. *In re Zaporski*, 366 B.R. 758, 770-71 (Bankr. E.D. Mich. 2007). Judge Shefferly granted a US Trustee motion to dismiss pursuant to 11 USC 707(b)(3)(B). While the Court granted the motion, it decided on several factors related to the debtor's overall financial circumstances. Material to this discussion is that the Court calculated the amount to be paid to creditors over the course of a hypothetical 60 month Plan. Specifically, the court considered the funds freed up following the completion of several 401(k) loans and calculated the benefit to creditors if those additional funds were committed to a Chapter 13 Plan following the loan payoffs. See below materials in section II. for a discussion of Judge Shefferly's interpretation of 11 USC 541(b)(7) and whether voluntary contributions are excluded from disposable income in the Chapter 13 context.
2. *In re Farkas,* No. 11-59772 WSD, Slip op., 2012 WL 3257855 (Bankr. E.D. Mich. August 1, 2012). Court granted the US Trustee's motion to dismiss, putting emphasis on the fact that the debtor, who scheduled continuing 401(k) loan repayments of $855.52 per month as of the petition date, was only 39 years old and had retirement savings of $127,070. Interestingly, in his analysis of a hypothetical Chapter 13, Judge Shapero found that both the debtor and the US Trustee erroneously deducted the actual 401(k) loan repayments from the disposable income analysis (Trustee's motion to dismiss only alleged that funds freed up after loans were paid off were disposable income). Though the debtor and Trustee agreed that actual 401(k) loan

repayments were excluded from disposable income, the Court calculated the debtor's hypothetical Chapter 13 disposable income by "[p]roperly characterizing all 401(k) loan repayments as disposable income. . ." *Id*. This ruling appears to be in direct conflict with the clear statutory language of 11 USC 1322(f) which states in relevant part that "any amounts required to repay such loan shall not constitute 'disposable income' under section 1325." 11 U.S.C. § 1322(f). *See also In Re Seafort*, 669 F.3d 662 at 666 (6th Cir. 2012).

3. *In re Beckerman,* 381 B.R. 841 (Bankr. E.D. Mich. 2008). Although the US Trustee's motion was granted based on a totality of the circumstances, the Court determined that the 55 year old debtor's contributions to a 401(k) were reasonable and necessary.
4. *In re Ray*, 325 B.R. 193 (Bankr. E.D. Mich. 2005). Finding that voluntary retirement contributions were properly excludable from disposable income/ability to pay analysis because debtor was 53 years old and only had $31,975 saved for retirement. The Court denied the Trustee's motion to dismiss which was based primarily on the fact that the debtor was contributing $556.83 per month to a 403(b) plan.
5. *In re Kehl*, 463 B.R. 19 (Bankr. E.D. Mich. 2011). Granting US Trustee's motion to dismiss partially on the grounds that the debtors, who were in their early 30's and had saved approximately $22,000 in retirement at the time of the petition, could stop contributing for 60 months and fund a Chapter 13 Plan and still have time to save a substantial amount for retirement (court calculated $232,093 using the debtors' current contributions commencing after a 60 month Plan and earning a 3% return).

6. *In Re Seafort*, 669 F.3d 662 at 666 (6th Cir. 2012). In this Chapter 13 case that will be discussed in depth later in the materials, the 6th Circuit Court of Appeals denied confirmation of a Chapter 13 Plan that proposed to use funds made available after the completion of a 401(k) loan repayment to contribute to a voluntary 401(k) plan instead of increasing their Chapter 13 payment at such time. However, the more material component of the opinion with respect to evaluation of a hypothetical Chapter 13 was the Court's suggestion that voluntary contributions in effect when the petition is filed should not be excluded from disposable income. *Id*. at 674 (footnote 7).

II. Voluntary Retirement Contributions in the Context of an Above –Median Chapter 13 Debtor – Properly Excluded from "Disposable Income?"

Since the effective date of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 and until recently, it appeared settled that voluntary retirement contributions to 401(k) and similar plans were excluded from "disposable income" available to fund a Chapter 13 Plan (i.e., debtors were allowed to continue voluntary contributions to 401(k) plans while in a Chapter 13 Plan even if the plan committed less than 100% to unsecured creditors). *See Baxter v. Johnson (In re Johnson),* 346 B.R. 256 (Bankr. S.D. Ga. 2006) (finding that "[d]ebtors are also permitted to shelter certain contributions to employee benefit plans (EBPs). '[*A*] *ny amount*' that is either 'withheld by' or 'received by' a debtor's employer for qualifying EBPs, deferred compensation plans, tax-deferred annuities, or state-law-regulated health insurance plans 'shall not constitute disposable income, as defined in section 1325(b)(2).' 11 U.S.C. § 541(b)(7)(A) & (B) (emphasis added in original). *Id*. at 263. The rationale in *Johnson* largely prevailed until 2010 when a Montana bankruptcy court rendered a decision with a fresh interpretation of 11 USC 541(b)(7)

and 11 USC 1325(b)(2) that has resulted in a line of cases agreeing with the Montana court's rationale and finding post-petition contributions are not excluded from disposable income. *See In re Prigge*, 441 B.R. 667 (Bankr. D. Mont. 2010).

A. Statutory Context – Above-Median Debtors

Like many provisions of BAPCPA, 11 USC 541(b)(7) was poorly drafted and results in significant ambiguity. Through the use of yet another "hanging paragraph" following 541(b)(7)(A)(i)(III) Congress has courts across the country struggling to interpret their intent. Section 541(b)(7)(A) states that property of the estate does not include "any amount withheld by an employer from the wages of employees for payment as contributions [to three different forms of retirement savings plans that qualify for tax deferment under the Internal Revenue Code of 1986] *except that such amount under this paragraph shall not constitute disposable income as defined in section 1325(b)(2).*" (emphasis added). As such, the interpretation of this provision is critical to the determination of whether voluntary contributions are excluded from disposable income for above median debtors. Several divergent interpretations of this provision have developed.

B. Summary of Divergent Interpretations

The court in *In re McCullers*, 451 B.R.498 (Bankr. N.D. Cal. 2011) summarized the varying interpretations as follows:

"(1) that the debtor may continue to contribute at the rate he or she contributed prepetition; (2) that the debtor may contribute the maximum amount permitted under the statute governing the type of plan at issue; and (3) that section 541(b)(7) does not authorize postpetition contributions in any amount." *Id*. at 501.

C. Cases finding that 401(k) contributions are excluded from disposable income

1. *Baxter v. Johnson (In re Johnson),* 346 B.R. 256 at 263 (Bankr. S.D. Ga. 2006) (finding that "[d]ebtors are also permitted to shelter certain contributions to employee benefit plans (EBPs). '[*A*] *ny amount*' that is either 'withheld by' or 'received by' a debtor's employer for qualifying EBPs, deferred compensation plans, tax-deferred annuities, or state-law-regulated health insurance plans 'shall not constitute disposable income, as defined in section 1325(b)(2).' 11 U.S.C. § 541(b)(7)(A) & (B) (emphasis added in original).

2. *In re Roth,* Bky. No. 10–13287, 2010 WL 2485951 (Bankr.D.N.J. Jun. 14, 2010) ("amounts withheld or received by employers from employees for various benefits plans are not property of the estate and are not disposable income for purposes of section 1323(b)(2)")

3. *In re Oltjen,* Bky. No. 07–60534, 2007 WL 2329695 (Bankr.W.D.Tex. Aug. 13, 2007) ("As excluded income, the contributions are not a deduction because they were never included in income in the first instance.")

4. *In re Devilliers,* 358 B.R. 849 (Bankr.E.D.La.2007) ("mandatory or voluntary contributions to qualified retirement plans are not property of the estate, nor are they considered when calculating disposable income." *Id*. at 859.)

5. *In re Njuguna,* 357 B.R. 689 (Bankr. D.N.H. Aug. 17, 2006) ("BAPCPA changed the way 401k contributions and loan payments are treated in Chapter 13. Congress sought to protect 401k contributions by excluding them from the bankruptcy estate and providing that neither 401k contributions nor 401k loan payments shall constitute disposable income." *Id*. at 691.)

6. *In re Zaporski*, 366 B.R. 758 (Bankr. E.D. Mich. 2007) (The court considered the issue in the context of a Chapter 7 motion to dismiss (pursuant to 707(b)(3)) as it evaluated the debtor's ability to pay in a hypothetical Chapter 13. The court granted the trustee's motion while finding that the debtor had an ability to pay a substantial dividend to creditors in a Chapter 13. However, the ruling only took into consideration funds available after the completion of 401(k) loan repayments in calculating the hypothetical distribution under a Chapter 13. The court explicitly rejected the US Trustee's argument that the debtor's voluntary contributions would be considered disposable income in a Chapter 13. The Trustee argued that 541(b)(7) included a "drafting error" and that deleting the word "not" in the hanging paragraph would render the provision less ambiguous. Judge Shefferly rejected this position and determined that "[a] more plausible reading, and one that does less violence to the statutory language, is that Congress intended the disposable income phrase to provide clarification or emphasis. In that case, a better word than 'except' may have been 'and.' Regardless, the Court is unwilling to adopt the UST's reading of the statute." *Id*. at 773 (footnote 2).

D. Recent cases finding that 401(k) contributions are *not* excluded from disposable income

1. *In re Prigge*, 441 B.R. 667 (Bankr. D. Mont. 2010)

In finding that voluntary contributions should not be excluded from disposable income, the court gave great weight and consideration to Congress's express exclusion of retirement loan repayments and their failure to include any such exclusion for voluntary contributions ("If Congress had intended to exclude voluntary

401(k) contributions from disposable income it could have drafted § 1322(f) to provide for such an exclusion, or provided one elsewhere." *Id*. at 677). The court also found significant that the IRS guidelines which provide the support for the expenditures in the means test state that such contributions are not a necessary expense. *Id*. The court then found that 541(b)(7) was simply intended to clarify that pre-petition withholdings that were still in the possession of the employer are not disposable income. *Id*. (citing 5 *Collier on Bankruptcy*, ¶ 541.22C[1] (15th ed. rev.) (stating that § 541(b)(7) "seems intended to protect amounts withheld by employers from employees that are in the employer's hands at the time of filing bankruptcy, prior to remission of the funds to the plan").

2. *In re McCullers*, 451 B.R.498 (Bankr. N.D. Cal. 2011)

The court agreed with the rationale of *In re Prigge* and found that "[i]n calculating disposable income, Debtor may deduct loan repayments to his 401(k) retirement plan only until that loan is repaid. So long as Trustee or an unsecured creditor objects, this above-median-income Debtor may not make voluntary postpetition contributions to his retirement plan." *Id*. at 505. Interestingly, the court went on to expressly limit its ruling to <u>above median</u> debtors (see below for discussion of below-median debtors). The court stated "the expenses that may be claimed by a below-median-income debtor are not limited to those specified in section 707(b) and the IRS guidelines, and such a debtor may be able to establish that voluntary contributions are reasonable and necessary expenses. In the present decision, the court decides only that section 541(b)(7) does not alter these general

rules, but was enacted for the very limited purpose described in *Prigge*." Id. (footnote 8).

3. *In re Parks*, 475 B.R. 703 (B.A.P. 9th Cir. 2012)

In determining that post-petition contributions are not excluded from disposable income (instead finding that 541(b)(7) applied only to pre-petition withholdings) the court stated that: "'such amount' referred to in the hanging paragraph of § 541(b)(7)(A) means that only prepetition contributions shall not constitute disposable income. As a consequence, we are persuaded that the term 'except that' in the hanging paragraph was designed simply to clarify that the voluntary retirement contributions excluded from property of the estate are not postpetition income to the debtor. Finally, to give meaning to the words 'under this subparagraph' found in the hanging paragraph, it is reasonable to conclude that 'Congress intentionally limited the type of contributions to qualified retirement plans that would be excluded from disposable income, namely those 'under this subparagraph', § 541(b)(7)(A), which in turn governs only those contributions in effect as of the commencement of a debtor's bankruptcy case, per § 541(a)(1).'" *citing In re Seafort,* 669 F.3d at 673. *Id*. at 708. (internal citations omitted). The court also found support for its ruling in 1306(a)(2) in that the provision "makes post-petition earnings property of the estate but nowhere in Chapter 13 are voluntary contributions excluded from disposable income." *Id*. at 708. The Court pointed out that in excluding post-petition loan repayments from disposable income Congress drafted 11 USC 1322(f) yet failed to include such an explicit provision with respect to voluntary contributions. Further, the Court found persuasive the fact that Section 1325(b)(2)(A)(i) referenced 707(b)(2) for determining

"amounts reasonably needed to be expended" for above median debtors and Congress did not include voluntary contributions as a reasonable and necessary expense in 707(b)(2). *Id*. at 709.

4. *In Re Seafort*, 669 F.3d 662 at 666 (6th Cir. 2012)

The *Seafort* was a consolidated case dealt with a proposed Chapter 13 plans that offered to increase contributions to a 401(k) Plan upon the debtors' completion of their 401(k) loan repayments (which was scheduled to occur post-confirmation). The trustee objected to the plan and argued that the funds freed up upon completion of the loan repayment constituted projected disposable income that should be committed to the plan. The bankruptcy court overruled the objection and ruled that the debtors could divert the funds to a voluntary contribution upon completion of the loans. The 6th Circuit BAP reversed. The debtors appealed and the 6th Circuit Court of Appeals affirmed the decision of the BAP. The BAP ruled that 541(b)(7) only operated to exclude from property of the estate and disposable income contributions that were in effect at the time of the petition and that post-petition income that becomes available after a 401(k) loan is repaid is not excluded from property of the estate or disposable income by 541(b)(7). *In re Seafort,* 437 B.R. 204, 208–09, 211–12 (B.A.P. 6th Cir.2010). In affirming the BAP decision, the 6th Circuit extended the significance of the ruling when it expressly disagreed with the trustee's concession that if the debtors had been contributing to the 401(k) at the commencement of the case, such amounts would be properly excluded from disposable income. The court stated that "[t]he Trustee 'concedes' that if a debtor is making voluntary retirement contributions when the bankruptcy petition is filed, such continuing contributions may be excluded from

disposable income. We do not agree with this assertion, for the reasons stated in *Prigge*. However, our view is not relevant here, because this issue is not presently before us." *Id*. at 674 (footnote 7). Although dictum, the footnote gives clear direction as to the court's position on whether voluntary retirement contributions should be excluded from "disposable income." The opinion strongly suggests that if an above median debtor proposes a Chapter 13 plan and excludes voluntary retirement contributions from their calculation of projected disposable income and the trustee or a creditor objects, the plan would not be confirmable.

III. Voluntary Retirement Contributions in the Context of a Below–Median Chapter 13 Debtor

The above cases involve above-median debtors. "Disposable income" is defined in relevant part as "current monthly income received by the debtor. . . less amounts reasonably necessary to be expended. . . for the maintenance and support of the debtor." 11 U.S.C. § 1325(b)(2)(A)(i). For above-median debtors, "amounts reasonably necessary to be expended" is determined pursuant to 11 USC 707(b)(2) (or the "means test"). 11 USC 1325(b)(3). Below-median debtors can still make the argument that such retirement contributions are reasonable and necessary expenses to be excluded from disposable income. However, there doesn't seem to be authority to depart from the pre-BAPCPA case law that consistently found that such contributions were not reasonable and necessary expenses in context of a Chapter 13 disposable income analysis. *See, e.g.*, *Behlke v. Eisen* (*In re Behlke*), 358 F.3d 429, 436 (6th Cir. 2004) (affirming the "bankruptcy court's finding that the 401K contribution in this case was not reasonably necessary to the maintenance and support of the debtors or their dependent and that it

should be included as disposable income"); *But see In re Mills,* 246 B.R. 395, 401-02 (Bankr.S.D.Cal.2000) (allowing a relatively low contribution to voluntary retirement to be excluded from disposable income for aging debtor with no other retirement provisions). Taking into consideration the *Seafort* dictum, a below-median debtor may have a better chance of excluding a voluntary retirement contribution from disposable income by arguing that on the facts of a given case a debtor's contribution is a reasonable and necessary expense.

IV. IRA Contributions

Given that qualified IRAs enjoy the same exemption protections as 401(k) and other employer sponsored retirement plans, should a voluntary IRA contribution be evaluated with the same standard as 401(k) contributions? There doesn't seem to be a rationale basis for differentiating between voluntary contributions to a 401(k) plan and contributions to an IRA. Particularly in the event a debtor does not have a 401(k) or similar plan available to him. At least with respect to below median debtors, the argument can be made in certain circumstances that IRA contributions are a reasonable and necessary expense, properly excluded from disposable income.

V. Status of State of Michigan Exemptions

Of course, debtors may elect to exempt their retirement accounts using the Michigan exemptions. The 6th Circuit Court of Appeals recently provided clarity with respect to the constitutionality of the Michigan bankruptcy specific exemption scheme set forth in MCL 600.5451. In the matter of *Richardson v. Shafer*, 689 F.3d 601 (6th Cir. 2012), the court reversed the 6th Circuit BAP decision and upheld the bankruptcy court's ruling that the Michigan bankruptcy specific exemption statute is constitutional, allowing bankruptcy

debtors to avail themselves of the state exemptions. The Michigan exemptions provide comprehensive protections with respect to tax qualified retirement savings. *See* MCL 600.5451(1)(l), (1)(m) . However, when electing the state exemptions, be aware that MCL 600.5451(1)(l) and MCL 600.5451(1)(m) state specifically that the respective exemptions exclude any contributions made to the retirement accounts within 120 days of the bankruptcy filing. This exclusion could be particularly important if a debtor engaged in pre-bankruptcy planning puts a lump sum into an IRA on the eve of the bankruptcy filing as discussed in these materials. A practitioner should ensure retirement contributions were made more than 120 days before the bankruptcy filing or are otherwise exempt under another provision of the state statute.

VI. Case Law Development – IRA Which Grants Lien On All Accounts is Not Exempt

A. *In re Daley*, 459 B.R. 270 (Bankr. E.D. Tenn. 2011)

The debtor in *Daley* claimed his interest in his Merrill Lynch IRA was exempt pursuant to Tennessee Code Annotated § 26–2–105(b) and 11 U.S.C. § 522(b)(3)(C). The Chapter 7 trustee objected to the debtor's claimed exemption on the grounds that the debtor engaged in a "prohibited transaction" as defined by 26 USC 4975, causing the IRA to lose its tax exempt status pursuant to 26 USC 408, in turn rendering the exemption provided for 11 U.S.C. § 522(b)(3)(C) (which requires the retirement account be "exempt from taxation under section. . . 408") inapplicable. The prevailing argument for the trustee alleged that by agreeing Merrill Lynch's standard Client Relationship Agreement which stated that "[a]ll of [the Debtor's] securities and other property in any account" are subject to a lien by Merrill Lynch, the debtor engaged in a "prohibited transaction." The court ruled that "[t]his grant of a lien at the IRA's inception constituted an extension of credit or guarantee, which is a prohibited

transaction under 26 U.S.C. § 4975(c)(1)(B)." *Id*. at 275. The court continued: [t]hrough no fault of his own and notwithstanding the fact that between its creation and the filing date, the Debtor conducted no borrowing transactions against the Merrill Lynch IRA, the Debtor indirectly engaged in a prohibited transaction under 26 U.S.C. § 4975 simply by signing the Client Relationship Agreements granting Merrill Lynch a lien on all of his accounts. Accordingly, the Debtor is not entitled to an exemption in the Merrill Lynch IRA holding $61,646.00 from a rollover which occurred on May 16, 2008." *Id*. at 280.

B. Local Authority

In a case in the Eastern District of Michigan, Judge Rhodes recently ruled consistent with the Eastern District of Tennessee bankruptcy court in sustaining the trustee's objection to the debtor's claimed exemption of a Merrill Lynch IRA with the exact same Client Relationship Agreement as that in effect in the *Daley* matter. As of the publication deadline for these materials, the decision is pending appeal to the district court.

EXEMPTION PLANNING OR BAD FAITH FRAUD?

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INTRODUCTION[1]

It is early March of 2012, and you have just been retained as counsel for a Chapter 7 Trustee. The case, In Re John Doe was filed in mid-February of 2012. As you review the bank records and account statements of the Debtor, you realize that just over a month before filing, Mr. Doe transferred Twelve Thousand ($12,000.00) Dollars into an Individual Retirement Account (IRA), and has exempted the IRA under a valid and applicable exemption. You quickly flip back to the Statement of Attorney Compensation and confirm what you thought: Mr. Doe was represented by his bankruptcy counsel at the time. After reading the applicable Internal Revenue Service (IRS) Rules, you determine that the Debtor, in fact, did not violate the applicable limits on IRA contributions according to the IRS Rules.

Now the questions stands: what, if any, grounds does your client, the Chapter 7 Trustee, have to pursue a claim against the Debtor. Moreover, what if any action should be taken against the Debtor's counsel? The simplest question is: was this transfer, on the eve of filing for relief, valid and legal exemption planning, or did it constitute bad faith, or even fraud?

ANALYSIS OF THE DEBTOR'S ACTIONS

As a general matter, upon the filing of a petition for bankruptcy, "all legal or equitable interests of the debtor in property" become property of the bankruptcy estate and will be

[1] For the purposes of this analysis, the author presumes that the federal exemption statutes enumerated in 11 U.S.C. § 522 are being used by the Debtor.

distributed to the debtor's creditors. 11 U.S.C. § 541(a)(1). The Trustee is charged with the duty to administer the Estate, including the duty to collect and reduce to money the property of the estate for which such trustee serves, and close such estate as expeditiously as is compatible with the best interests of parties in interest, investigate the financial affairs of the debtor; and if advisable, oppose the discharge of the debtor. 11 U.S.C. § 704.

In general, "exemptions are to be liberally construed in favor of debtors in order to give full effect to the legislative intent of providing a fresh start." *In re Bates*, 123 B.R. 38, 40 (Bankr. S.D. Ohio 1990). However, the Debtor's pre-bankruptcy actions should lead the Trustee to fully investigate the appropriateness of Debtor's IRA contributions and determine an appropriate course of action, if any, to take.

In this instance, the pre-bankruptcy "exemption planning" could be called into question by the Trustee who may pursue an objection to the claimed exemption, a fraudulent transfer cause of action, and/or an objection to the Debtor's discharge. The Debtor will undoubtedly assert that he was merely trying to take advantage of legitimate exemptions.

THE TRUSTEE'S AVAILABLE OPTIONS

Option #1 – Objection to Exemptions

One option the Trustee has at his or her disposal for pursuit of collection for the Estate of the asset which was exempted on the eve of bankruptcy, as described herein, is to object to the Debtor's claimed exemption of the asset.

Objections to Debtor's exemptions are brought under 11 U.S.C. §522, and are generally in the form of explanations as to why the Trustee believes that a certain asset of the Debtor does not fit within one or more of the described exemptible categories of §522(d).

In a situation such as the instant, the Trustee would have to articulate to the Court an argument as to why the eve-of-bankruptcy transfer of the particular asset(s) into a given exemptible category voids the Debtor's ability to claim an exemption. This, however, is bound to be a difficult argument to assert. A leading commentator states, "Section 522 continues to adopt the position favorably viewed by the Code drafters that the mere conversion of nonexempt property into exempt property, without fraudulent intent, does not deprive the debtor of exemption rights in the converted property." 4 Collier on Bankruptcy ¶ 522.08[5].

Option #2 – Fraudulent Transfer Litigation

A second option the Trustee has at his or her disposal for pursuit of collection based upon an exempted asset, which was exempted on the eve of bankruptcy, as described herein, is to pursue an action against the Debtor for a fraudulent transfer.

The Trustee's cause of action for a fraudulent transfer arises from 11 U.S.C. §548(a)(1), which states:

> (a)
> (1) The trustee may avoid any transfer (including any transfer to or for the benefit of an insider under an employment contract) of an interest of the debtor in property, or any obligation (including any obligation to or for the benefit of an insider under an employment contract) incurred by the debtor, that was made or incurred on or within 2 years before the date of the filing of the petition, if the debtor voluntarily or involuntarily—
> (A) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted; or
> (B)
> (i) received less than a reasonably equivalent value in exchange for such transfer or obligation; and
> (ii)

> (I) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;
> (II) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital;
> (III) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured; or
> (IV) 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.

Under §548(a)(1)(A), the Trustee may move to avoid the transfers, to the extent they were made within two (2) years before the filing of the petition, on the theory that such transfers were made with the actual intention to hinder delay or defraud a creditors.

Under §548(a)(1)(B)(ii)(I), the Trustee may move to avoid these transfers, to the extent they were made within two (2) years before the filing of the petition, on the theory that such transfers were made for less than reasonably equivalent value, and that the debtor was insolvent at the time of the transfers, or became in solvent as a result of the transfers.

Under §548(a)(1)(B)(ii)(II), the Trustee may move to avoid these transfers, to the extent they were made within two (2) years before the filing of the petition, on the theory that the transfers were made for less than reasonably equivalent value, and the transfers resulted in the Debtor being left with unreasonably small capital.

Under §548(a)(1)(B)(ii)(IV), the Trustee may move to avoid a transfers on the theory that such transfers were made for less than reasonably equivalent value, and the transfers were made to the Debtor himself, arguable qualifying as an "insider."

Option #3 – Objection to Discharge

Many courts have addressed the type of planning engaged in by the Debtor in the above scenario. While the case law regarding whether such pre-bankruptcy conversions may constitute a fraud on creditors is split, the general proposition is that the mere conversion of non-exempt assets into exempt assets does not, by itself, establish fraud. See, *Smiley v. First Nat'l Bank of Belleville (In re Smiley)*, 864 F.2d 562, 566 (7th Cir. 1989); *Norwest Bank Nebraska, N.A. v. Tveten*, 848 F.2d 871, 873-74 (8th Cir. 1988); *Ransier v. Public Employees Retirement System (In re Cottrill)*, 118 B.R. 535, 539 (Bankr. S.D. Ohio 1990); *Staats v. Beckman (In re Beckman)*, 104 B.R. 866, 870 (Bankr. S.D. Ohio 1989). These courts tend to rely heavily on the legislative history and the reports of the House and Senate Judiciary Committee dealing with a debtor's right to claim exemptions, which states:

> As under current law, the debtor will be permitted to convert nonexempt property into exempt property before filing a bankruptcy petition. The practice is not fraudulent to creditors, and permits the debtor to make full use of the exemptions to which he is entitled under law.
>
> S. Rep. No. 95-989 (1978) *reprinted in* 1978 U.S.C.C.A.N. 5787; H.R. Rep. No. 95-595 (1977) *reprinted in* 1978 U.S.C.C.A.N. 5963.

Additionally, the case law tends to agree that "the intent to effectuate a legal transfer to exercise one's right to exemptions provided under the law cannot constitute an illegal fraud." *In re Wadley*, 263 B.R. 857 (Bankr. S.D. Ohio 2001); (*quoting Abbott Bank-Hemingford v. Armstrong (In re Armstrong)*, 931 F.2d 1233, 1238 (8th Cir. 1991). In essence, the courts have held that a debtor who engages in such pre-bankruptcy exemption planning would lack the requisite fraudulent intent because it would be in line with the very purpose of the exemptions.

Despite congressional intent, however, other courts have found that given extrinsic evidence of fraud, the Debtor's claim of exemptions could be considered an illegal fraud. In fact, it has been found that the same conduct that deemed to not necessarily be fraudulent to creditors, the same conduct should lead to a denial of the debtor's discharge if extrinsic signs of fraud are present. *Smiley v. First Nat'l Bank of Belleville (In re Smiley)*, 864 F.2d 562, 567 (7th Cir. 1989).

"The exception is fact sensitive with a judge's determination often hinging on whether, in the judge's view of the debtor's attempt to maximize exemptions, "a pig becomes a hog." *Noland v. Wadley (In re Wadley)*, 263 B.R. 857, 860 (Bankr. S.D. Ohio 2001); (*quoting, Albuquerque National Bank v. Zouhar (In re Zouhar)*, 10 B.R. 154, 157 (Bankr. D. N.M. 1981) (further citations omitted)).

It appears from the applicable jurisprudence that courts tend to review the totality of the circumstances surrounding the transaction as well as the debtor's forthrightness in his disclosure of the pre-bankruptcy planning conversion. Factors that courts have considered to determine if extrinsic evidence of fraud is present include:

1) Whether the transfer occurred immediately prior to the bankruptcy (*Beckman*, 104 B.R. at 871);
2) Whether the debtor converted a large amount of assets or the assets were of high value (*Tveten*, 848 F.2d at 876);
3) Whether the transfer was a reaction to a judgment entered against the debtor (*Ford v. Poston (In re Ford)*, 773 F.2d 52, 55 (4th Cir. 1985));
4) Whether the debtor received inadequate consideration for the transfer (*Panuska v. Johnson (In re Johnson)*, 880 F.2d 78, 82 (8th Cir. 1989));

5) Whether the debtor continued to use the property transferred (*Wilder Health Care Center v. Elholm (In re Elholm)*, 80 B.R. 964, 970 (Bankr. D. Minn. 1987));

6) Whether the debtor was rendered insolvent by the transfer (*In re Moore*, 177 B.R. 437, 442 (Bankr. N.D.N.Y. 1994)); and

7) Whether the conversion was accompanied by concealment or conduct by the debtor calculated to mislead creditors (*Smiley*, 864 F.2d at 568; *Beckman*, 104 B.R. at 871).

ANALYSIS OF THE ATTORNEY'S ACTIONS

The analysis now turns to the behavior of Debtor's counsel. The simple questions is: should an attorney advise a client in this matter? With respect to this issue, guidance comes from several passages of the Michigan Rules of Professional Conduct ("Professional Rules").

First, one should naturally turn to the Preamble of the Professional Rules; often referenced for its explination that lawyer ought zealously advocate for his client.

> ***Preamble: A Lawyer's Responsibilities***
>
> This preamble is part of the comment to Rule 1.0, and provides a general introduction to the Rules of Professional Conduct.
>
> A lawyer is a representative of clients, an officer of the legal system and a public citizen having special responsibility for the quality of justice.
>
> As a representative of clients, a lawyer performs various functions. As advisor, a lawyer provides a client with an informed understanding of the client's legal rights and obligations and explains their practical implications. As advocate, a lawyer zealously asserts the client's position under the rules of the adversary system. As negotiator, a lawyer seeks a result advantageous to the client but consistent with requirements of honest dealing with others. As intermediary between clients, a lawyer seeks to reconcile their divergent interests as an advisor and, to a limited extent, as a spokesperson for each client. A lawyer acts as evaluator by examining a client's legal affairs and reporting about them to the client or to others.

If one were to focus soley on the statement that, "a lawyer zealously asserts the client's position under the rules of the adversary system," it would be possible to argue that, without limitation, a lawyer absolutely may counsel his client in this regard.

However, the analysis does not stop there. The Preamble itself, in fact, states: "A lawyer is […] an officer of the legal system and a public citizen having special responsibility for the **quality of justice.**" (Emphasis added). In a the following paragraph, the Premable instructs that, "a lawyer seeks a result advantageous to the client **but consistent with requirements of honest dealing with others.**" (Emphais added).

Thus, even from the Preamble alone, it can be gleened that an attorney may not counsel his client in a matter which would be contrary to the concepts of honesty and fair dealing, or in other words: fraudulent.

Further, however, Rule 1.2(c) specifically admonishes attorneys that they may not participate in or assist a client in conduct that the attorney knows is illegal or fraudulent. The rule reads as follows.

> ***Rule 1.2(c)***
> (c) A lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is illegal or fraudulent, but a lawyer may discuss the legal consequences of any proposed course of conduct with a client and may counsel or assist a client to make a good-faith effort to determine the validity, scope, meaning, or application of the law.

The conclusion with respect to the role of an attorney in a debtor's pre-bankruptcy exemption planning, therefore, is as malleable as the analysis regarding the nature of the planning itself. As recognized by the court in *In re Warren,* 512 F.3d 1241 (10th Cir.2008), this can be a significant dilemma for debtors' counsel. The court in *Warren* stated, "[T]he same conduct can be malpractice *not* to advise in one jurisdiction, but voidable and grounds for denial

of discharge and possibly for disbarment in another....” *Id*. at 1249 (quoting John D. Ayer, *How to Think About Bankruptcy Ethics,* 60 Am. Bankr.L.J. 355, 374 (1986)).

While some Courts may hold that certain pre-bankruptcy exemption planning may rise to the level of fraud; others have held that the conversion of non-exempt assets into exempt assets on the "eve of bankruptcy" is not fraudulent per se. *Gill v. Stern (In re Stern)*, 345 F.3d 1036, 1044-45 (9th Cir. 2003). Indeed, where the only evidence presented is that non-exempt assets were "deliberately converted to exempt assets just prior to filing the bankruptcy petition," such evidence is "insufficient as a matter of law to establish fraud." Id. (quoting *Wudrick v. Clements*, 451 F.2d 988, 990 (9th Cir. 1971)).

In other words, debtors may maximize their exemptions, even when they do so shortly before the filing of a bankruptcy petition. See also *House Report of Bankruptcy Reform Act of 1978*, H.R. REP. NO. 95-595, at 361 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6317 ("As under current law, the debtor will be permitted to convert nonexempt 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."). *In re Thomas*, 2012 Bankr. LEXIS 3126, 10-11 (Bankr. D. Idaho July 9, 2012)