

*Best Practices in Client Advocacy:  
From Beginning to Bitter End*

**Chapter 7 Breakout**

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# DISCOVER



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## Best Practices in Debtor Representation: Pre-Bankruptcy Planning

### HYPOTHETICALS

By Julia D. Loper and Joseph A. Baldi - Baldi Berg, Ltd.

The following hypothetical scenarios are for discussion purposes. As you read, consider the issues that might arise based on the fact patterns including which questions to ask your client, which documents to request, which options may be appropriate under the circumstances and generally how to best represent your client.

1. A potential client comes in for a consultation while a lawsuit is pending against him. When asked if there is anyone else he owes money to, he says that he owes his mom about \$10,000. When asked about payments to creditors in the last 90 days or insiders in the last year, the client says that last month he paid his mom back \$9,000 from his recently received income tax refund and that he still has about 8,000 left over from his refund. Later, when you receive the completed questionnaire, the mother is not listed on Schedule F or on the Statement of Financial Affairs. When you ask the client about this, he says that he doesn't want his mom to know about the bankruptcy and that it will break her heart. When you explain the disclosure requirements he insists that it was just a gift and that he doesn't actually owe her the money.
2. You are preparing a chapter 7 case for a client who appears to have primarily business debts. The client has not listed any of her corporations or LLCs on her Statement of Financial Affairs. She is unsure about when the entities were formed. Additionally, you know that the client has sold off some of her property over the last few years in order to pay bills including your attorneys' fees. When you ask for a list of the property sold with dates, value at time of sale and price received, she tells you that she didn't really sell it, but gave the jewelry to her grandchildren as gifts about a year ago and her sons gave her some money for several automobiles approximately three years ago, but she didn't write it down.
3. A client is seeking to file bankruptcy. He and his wife personally guaranteed millions in corporate debts and are now mired in hotly contested litigation. They own a rental property free and clear, but their homestead property has no equity. Additionally, they have transferred the ownership of some assets, including life insurance policies to a trust in order to protect it from the reach of creditors. The client doesn't want the creditors to get at this equity because he had planned on using the investment to pay for his children's college education and for one child with special needs.
4. A client has inherited an IRA and a house from his father who passed away two months ago. This inheritance and his own 401k are his only assets. He was unable to keep his job while he cared for his father, so is currently unemployed. As a result of the unemployment, he has several lawsuits pending against him and a judgment may be issued any day. Debtor's wife is employed but is currently on maternity leave from her job with reduced income.
5. A client has three investment properties that are cash flowing but under water. One of the properties is currently in foreclosure. The client can pass the means test if she deducts the secured pay-

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ments against the properties. The client thinks that some of funds received from cash-out second mortgages were used for personal expenses in addition to repairs and updates to the property, but is not sure as her ex-husband handled all of the rental property management. The client wants to wash her hands of the whole mess and let the properties go.

6. Son's name is on his aging mother's bank account on which he is a signatory for convenience purposes. He writes checks out of this account to make mortgage payments on the home where they both live. He also writes checks for food and household expenses. He does not want to list this account on his schedules since all of the money in the account is from his mother's investments and social security. His mother has also set up a spendthrift trust for her son and it appears as if this trust is not property of the estate.
  
7. In order to protect the equity in their house from the wife's creditors, a couple wants to transfer their property from joint tenancy to tenancy by entirety. No litigation is currently pending, but the wife has defaulted on loans and is worried that she will lose the house. During your thorough investigation of the debtor's financial affairs, you discover that a judgment lien was placed against the property a few years ago.

# Best Practices in Debtor Representation: Pre-Bankruptcy Planning

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## INTRODUCTION

Have you ever stopped to consider what are the duties of a debtor's attorney to properly counsel their client regarding the decision to file a bankruptcy, the timing of the filing and what, if anything, the client can do to protect their assets from risk of loss to a Chapter 7 Trustee or to minimize their Chapter 13 payments? Proper pre-bankruptcy planning begins with a thorough review of a client's assets and liabilities and income and expenses, for the purpose of determining whether the filing of a bankruptcy is a good option for managing or even eliminating some or all of their debt. Factors to consider include the nature of the debt, whether there are sufficient assets or income to pay or settle with creditors, the client's overall financial picture and their short-term and long-term goals. Consideration should also be given to what else is going on in their lives, how urgent their financial concerns are, and whether non-bankruptcy options are available. To assist you in your initial client meetings, we have prepared and provided a New Client Checklist in the Appendix.

Clients who have the benefit of time and who are not currently insolvent may also be able to engage in asset protection planning to protect some or all of their otherwise non-exempt assets in a bankruptcy. No, we are not advocating that we encourage our clients to engage in fraudulent transfers or otherwise hinder, delay or defraud their creditors. However, as the following survey of cases shows, clients may, under the appropriate circumstances, take advantage of their available state and federal law exemptions by converting non-exempt assets into exempt assets and thereby shelter certain assets that would otherwise fall into the hands of their creditors.

Whether a debtor's conversion of nonexempt assets into exempt assets will survive a court's scrutiny depends upon the jurisdiction and a variety of other factors. Debtors who engage in asset protection planning with the intent to hinder, delay, or defraud creditors put themselves at risk of having the transaction set aside as a fraudulent transfer, having the exemption denied, having their discharge denied, or having their petition dismissed. Attorneys who assist their clients in such conduct are also at risk of being sanctioned. Typically, the analytical framework used to resolve these issues is the "badges of fraud." Commonly cited badges of fraud include: (1) the family or insider relationship between the transferor and transferee; (2) the debtor retaining control

of the property in question; (3) the transfer taking place abruptly, i.e. immediately following the filing of a lawsuit, after entry of a judgment or right before a bankruptcy; (4) the debtor becoming insolvent as a result of the transfer; (5) the conversion occurring after the entry of a large judgment against the debtor; (6) the secrecy of the transaction; (7) the debtor not receiving adequate consideration for the transfer; and (8) the failure to make full disclosure of assets.

The following survey of cases addresses various types of asset protection planning. Section I addresses the purchase of property with the intent to convert into exempt property or in fraud of creditors. Section II addresses the fraudulent transfer of assets into a self-settled trust or similar device. Section III addresses restrictions on debt relief agencies. Section IV addresses attorney sanctions for improper disclosure. Sections V and VI address permissible and impermissible attempts at pre-bankruptcy asset protection planning. Lastly, the conclusion is found in Section VII.

### I. 735 ILCS 5/12-1001. PERSONAL PROPERTY EXEMPT

**1. If a debtor owns property exempt under this Section and he or she purchased that property with the intent of converting nonexempt property into exempt property or in fraud of his or her creditors, that property shall not be exempt from judgment, attachment, or distress for rent. Property acquired within 6 months of the filing of the petition for bankruptcy shall be presumed to have been acquired in contemplation of bankruptcy. 735 ILCS 5/12-1001.**

*a. Medaris v. Commercial Bank of Champaign*, 118 Ill. 2d 443 (1987) (debtors could not claim any portion of automobile as exempt where automobile was acquired less than five months prior to their filing for bankruptcy).

**i. Key Factor(s):** plaintiffs acquired automobile less than five months prior to filing for bankruptcy.

*b. Soc’y of Lloyd’s v. Collins*, 284 F.3d 727 (7th Cir. 2002) (premiums paid on life insurance policies owned by judgment debtor could not be garnished by judgment creditor, even if statute applied, given absence of showing that judgment debtor acted with requisite intent to convert nonexempt property to exempt property; Judgment creditor failed to raise presumption that judgment debtor’s continued payment of premiums for life insurance policies he owned was fraudulent given that judgment debtor was solvent and did not transfer property for inadequate consideration).

**i. Key Factor(s):** no showing that debtor acted with intent to convert nonexempt property to exempt property; debtor was solvent and did not transfer property for inadequate consideration.

*c. In re Holtermann*, 1999 WL 33582613 (Bankr. C.D. Ill. June 21, 1999) (court al-

lowed trustee's objection to debtors' claim of exemption despite debtors' claim that the balance of funds they withdrew from an individual retirement account and held in a savings account were exempt).

- i. **Key Factor(s):** debtors did not roll the cash value into a spendthrift trust, IRA, or other protected plan; funds "lost the attributes of life insurance proceeds" once they were transferred to the debtors' account.

## II. 11 U.S.C. § 548. FRAUDULENT TRANSFERS AND OBLIGATIONS

1. **In addition to any transfer that the trustee may otherwise avoid, the trustee may avoid any transfer of an interest of the debtor in property that was made on or within 10 years before the date of the filing of the petition, if-- (A) such transfer was made to a self-settled trust or similar device; (B) such transfer was by the debtor; (C) the debtor is a beneficiary of such trust or similar device; and (D) the debtor made such transfer 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, indebted. 11 U.S.C. § 548(e)(1).**

- a. *In re Castellano*, 2014 WL 3881338 (Bankr. N.D. Ill. Aug. 6, 2014) (transfer of debtor's interest in assets of living trust to spendthrift trust was avoidable fraudulent conveyance).

- i. **Key Factor(s):** debtor was beneficiary of spendthrift trust; timing of creation of the spendthrift trust account appeared to have been dictated in large part by debtor's insolvency and bankruptcy petition; debtor's understanding was that the spendthrift trust account was created to prevent her creditors from reaching the assets; timing of transfer of funds was delayed until a spendthrift trust had been created.

- b. *In re Mortensen*, 2011 WL 5025249 (Bankr. D. Alaska May 26, 2011) (debtor transferred real property to trust with "actual intent to hinder, delay, or defraud his creditors").

- i. **Key Factor(s):** debtor was well "under water" when he sought to put the property out of reach of his creditors by placing it in the trust; debtor used trust as a vehicle for making stock market investments (as well as to make loans to acquaintances), not for its stated purpose to preserve property for his children.

- c. *In re Mastro*, 465 B.R. 576 (Bankr. W.D. Wash. 2011) (transfers by involuntary Chapter 7 debtor of residential properties and other assets into self-settled trusts were both void).

- i. **Key Factor(s):** debtor made transfers with intent to hinder, delay, or defraud creditors; no consideration was paid for transfers; transfers occurred at a time when debtor was insolvent.

**III. 11 U.S.C. § 526(a)(2). RESTRICTIONS ON DEBT RELIEF AGENCIES**

1. **A debt relief agency shall not make any statement, or counsel or advise any assisted person or prospective assisted person to make a statement in a document filed in a case or proceeding under this title, that is untrue or misleading, or that upon the exercise of reasonable care, should have been known by such agency to be untrue or misleading. 11 U.S.C. § 526(a)(2).**

a. *Parker v. Jacobs*, 466 B.R. 542 (M.D. Ala. 2012) *aff'd sub nom. In re Parker*, 485 F. App'x 989 (11th Cir. 2012) (attorney disbarred from practice of law in district's bankruptcy court; attorney repeatedly violated Rule 9011(b)(3) and § 526(a)(2) by filing materially false petitions and schedules and repeatedly withheld payment of filing fees).

- i. **Key Factor(s):** numerous instances in which attorney had filed petitions and other papers knowing that they contained false information; attorney's fraudulent conduct in his own Chapter 7 case where he falsified his name and home address to avoid creditor detection; 28 cases in which attorney did not include required filing fee; record demonstrated violations of state professional conduct rule; attorney habitually came to court late and unprepared and, many times, did not attend scheduled hearings at all.

a. *In re Casavalencia*, 389 B.R. 292 (Bankr. S.D. Fla. 2008) (Chapter 13 petition filed by debtor in attempt to discharge debts arising out of deliberately fraudulent scheme to deceive investors dismissed as having been filed in bad faith, so as to permit investors to proceed with their suits against debtor, where debtor, in omitting numerous assets from bankruptcy schedules and in failing to disclose, on petition, the alias under which he had consistently held himself out to investors, had sought bankruptcy relief while engaging in deliberate effort to mislead creditors and court).

- i. **Key Factor(s):** petition and schedules filed were untrue and misleading and at least some of them (particularly including the debtor's nomenclature) would have been known to debtor's attorney upon the exercise of reasonable care.

b. *In re Clink*, 497 B.R. 44 (W.D. Mo. 2013) (former attorney for debtor sanctioned for advising his client to omit any reference to potentially preferential prepetition transfer to client's mother in documents filed in bankruptcy case).

- i. **Key Factor(s):** attorney recommended that client conceal from the official records a substantial transaction with her mother that looked like a preference for a favored creditor; attorney condoned a reported practice of minimizing the reporting of assets such as pets, including horses, some of which, as in this case, may have significant value; attorney disregarded procedural rules such as having a written contract with a debtor and obtaining signed verification of final drafts of papers prior to filing.

#### IV. SANCTIONS AGAINST DEBTOR'S COUNSEL FOR IMPROPER DISCLOSURES

##### 1. Counsel sanctioned under 11 U.S.C. §§ 105 and 329 and Model Rule 3.3 for their failure to file a materially accurate Schedule B on behalf of the Debtor, and timely file a fee disclosure statement required under § 329(a) and Bankruptcy Rule 2016(b).

- a. *In re Varan*, 2014 WL 2881162 (Bankr. N.D. Ill. June 24, 2014) (attorneys failed to accurately disclose assets in schedules and failed to comply with fee disclosure requirements; bankruptcy court ordered the debtor's attorneys to disgorge all fees, reimburse the U.S. Trustee for the cost of pursuing a sanctions motion against them, and complete of a professional responsibility course at an ABA-approved law school).

- i. **Key Factor(s):** documents produced during discovery and the debtor's deposition testimony shows that attorneys knew or should have known that schedules were materially inaccurate as filed; absolute duty to disclose assets in his schedules, regardless of the value of such assets; disclosure of assets to trustee is not sufficient to comply with the Bankruptcy Code's requirement of the filing of accurate schedules; attorneys failed to comply with fee disclosure requirements on numerous occasions.

#### V. PERMISSIBLE PRE-BANKRUPTCY ASSET PROTECTION PLANNING

##### 1. Engage in exemption planning while faced with financial distress.

- a. *In re Woller*, 483 B.R. 886 (Bankr. W.D. Wis. 2012) (debtors sought to protect \$200,000 in exempt assets and discharge \$164,000 in debt; noting "[t]he fact that a debtor engages in exemption planning while faced with financial distress is not itself evidence of fraudulent conduct. . . . the use of exemptions is at least a legitimate form of asset protection, and debtors should only be penalized when they go beyond taking advantage of the exemption laws themselves;" the court went on to describe the absence of extrinsic evidence of fraud even though certain sale proceeds were held by a lawyer for 18 months before the funds were converted to an exempt annuity).

- i. **Key Factor(s):** no sufficient evidence of "extrinsic" activity actually intended

to hold creditors at bay while debtors purchased the annuity; debtors' exemption planning did not rise to the level of fraudulent conduct – “conduct which forestalled or potentially deceived creditors, buying time while they surreptitiously converted non-exempt assets into exempt ones” – as would have warranted denial of their exemption of the annuity; exemption statute did not automatically prohibit debtors from exempting vehicle – a semi-trailer – under the business property exemption; nothing in the statute limited “income” to wages from employment, as opposed to money owed to independent contractors.

**2. Liquidate nonexempt assets to reduce or prepay mortgage on homestead.**

*a. In re Carey*, 938 F.2d 1073 (10th Cir. 1991) (debtor's negotiating a mortgage to permit prepayment of principal without penalty does not infer any fraud on creditors; conversion is insufficient to support denial of discharge).

*i. Key Factor(s):* debtor had no intent to hinder, delay, or defraud her creditors; debtor fully disclosed all payments and transfers in her bankruptcy schedules and at the meeting of creditors; debtor retained no beneficial interest in any converted property; debtor did not obtain credit to purchase exempt property.

*b. In re Meyer*, 244 F.3d 352 (4th Cir. 2001) (debtor's use of nonexempt fund to prepay mortgage debt and to increase equity in homestead property was not avoidable as transfer which was made other than “upon consideration deemed valuable in law;” release of mortgage lien constituted “valuable consideration” for debtor's prepayment, and foreclosed application of voluntary conveyance statute).

*i. Key Factor(s):* release of mortgage lien constituted “valuable consideration” for debtor's prepayment.

*c. In re Martiny*, 378 B.R. 52 (Bankr. W.D. N.Y. 2007) (pre-bankruptcy planning was approved whereby debtors increase equity in homestead by using nonexempt assets to reduce the mortgage; court held that absent fraud, such planning and execution was not improper).

*i. Key Factor(s):* no provision of the Bankruptcy Code or of the New York statute prohibits pre-bankruptcy planning for the purpose of maximizing the exemptions allowed to a debtor; exemption was enhanced to a level within the statutory limit.

*d. In re Addison*, 540 F.3d 805 (8th Cir. 2008) (conversion of \$11,500 of nonexempt assets to pay down mortgage on exempt homestead was proper even though: (i) a trans-

fer was made to an insider, (ii) the debtor retained control of the property, and (iii) the debtor was insolvent, none of which constituted evidence of fraud extrinsic to the very conversion. The only such evidence, i.e., transaction occurred in the face of litigation, was insufficient to result in a denial of the exemption; the court ruled the same with respect to debtor's \$4,000 IRA; the court also declined to deny the debtor's discharge, ruling that the "the same standard applies to determine whether a discharge should be denied or whether a transfer of nonexempt property to exempt property should be voided; both require proof that the debtor acted with the intent to hinder, delay, or defraud a creditor.")

- i. **Key Factor(s):** debtor did not act with intent to hinder, delay or defraud creditors; no extrinsic evidence of any intent to defraud creditors.

**3. Convert nonexempt funds into reasonable amount of exempt insurance.**

a. *In re Holt*, 894 F.2d 1005 (8th Cir. 1990) (court upheld lower court finding of no fraud in connection with the conversion of nonexempt funds into reasonable amount of exempt insurance; the court confirmed that a debtor may convert nonexempt assets into exempt assets on the eve of bankruptcy; the conversion, however, must not be done with intent to defraud creditors as manifested by extrinsic evidence).

- i. **Key Factor(s):** no intent to defraud creditors; debtors did not have exorbitant amounts of existing life insurance coverage before they openly purchased reasonable amounts of additional coverage; money placed into exempt property was not borrowed; no evidence that they lied to or misled creditors.

**4. Transfer assets to a retirement plan.**

a. *Schwartzman v. Wilshinsky*, 50 Cal. App. 4th 619 (2d Dist. 1996) (transfer of assets to a retirement plan which might otherwise be fraudulent is permitted if the funds qualify for an exemption; lower court erred in denying the judgment debtor's claim of exemption as to all employee contributions and matching employer contributions held in the 401K profit-sharing account established by the judgment debtor's employer).

- i. **Key Factor(s):** no evidence the debtor had kind of control that would show a nonretirement purpose.

**5. Conduct fire sale to convert nonexempt assets to exempt assets.**

a. *In re Kemmer*, 265 B.R. 224 (Bankr. E.D. Cal. 2001) (mere act of conversion not fraudulent; actual fraudulent intent not established by fire sale undertaken solely in an attempt to convert nonexempt assets into exempt assets, which did not exceed the

bounds of acceptable exemption planning; transfer was made for less than “reasonably equivalent value” and was subject to avoidance on that basis).

- i. Key Factor(s):** no actual fraudulent intent; debtors were not seeking to hide their assets but merely to make maximum use of available exemptions.

**6. Convert nonexempt assets into an exempt annuity.**

**a. *In re Vangen*, 334 B.R. 241 (Bankr. W.D. Wis. 2005)** (conversion of nonexempt into exempt assets was not improper absent evidence of fraud extrinsic to the very act of conversion; limitations on amount of funds converted is for the legislature to determine not the courts; accordingly, debtor was allowed to convert \$136,000 into an exempt annuity, which the court characterized as “not particularly sizeable”).

- i. Key Factor(s):** plaintiffs failed to present sufficient extrinsic evidence of fraud to overcome the general rule that a debtor may arrange her affairs so as to take full advantage of the exemptions available to her under state law; no basis for considering the money the debtor used to fund the annuities to have been “tainted” in any way; no evidence that she sold her interest in a building for anything other than fair market value; motivation was to create a retirement fund for debtor’s future.

**b. *In re Simms*, 243 B.R. 156 (Bankr. S.D. Fla. 2000)** (conversion into exempt annuity was approved where debtors were concerned about their advancing ages and declining health and, therefore, were interested in long-term investment, which the annuity provided).

- i. Key Factor(s):** trustee failed to establish that debtors’ act of converting the non-exempt funds into an exempt annuity was done with intent to hinder, delay, or defraud creditors; debtors decided a full year before filing bankruptcy to sell their prior homestead property and establish the subject property as homestead, and their reasons for doing so were legitimate, compelling, and independent of any alleged scheme to defraud creditors.

**c. *In re Robinson*, 271 B.R. 437 (Bankr. N.D. N.Y. 2001)** (conversion of nonexempt real property into exempt annuities for \$5,000 made seven months before filing a petition and the advice of counsel was allowed).

- i. Key Factor(s):** lack of evidence of extrinsic fraud; debtors were elderly and insolvent but paid fair consideration; husband was 74 years old and was continuing to work to support his family; his wife was in ill health; the annuities

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were purchased in anticipation of their future needs; the conversion was made seven months before the bankruptcy petition was filed.

*d. In re Bogue*, 240 B.R. 742 (Bankr. E.D. Wis. 1999) (pre-bankruptcy conversion of assets from nonexempt to exempt within a year of filing a bankruptcy petition is not necessarily fraudulent to creditors, and to find such fraudulent intent there must be “extrinsic signs of fraud”).

**i. Key Factor(s):** no extrinsic signs of fraud shown; amount of exemption not exorbitant; funds used by the debtors to purchase the annuities were not tainted; no misrepresentations or concealment; purpose was to create a retirement fund for their future.

### 7. Convert nonexempt proceeds from personal property sold with debtor’s house into homestead property.

*a. In re Danduran*, 657 F.3d 749 (8th Cir. 2011) (Noting that the proceeds from the sale of personal property could qualify for the homestead exemption “but if directed properly;” noting that “[i]t is well established . . . that a debtor’s conversion of non-exempt property to exempt property on the eve of bankruptcy for the express purpose of placing that property beyond the reach of creditors, without more, will not deprive the debtor of the exemption to which he otherwise would be entitled”).

**i. Key Factor(s):** trustee failed to meet burden of establishing conversion was invalid absent evidence that the proceeds of the sale of the house and personal property were ever segregated or that only the proceeds of real property (and none of the proceeds of personal property) were used to pay off the mortgage.

### 8. Convert assets from nonexempt to exempt prior filing bankruptcy.

*a. In re Wadley*, 263 B.R. 857 (Bankr. S.D. Ohio 2001) (debtor sold motorcycle for \$12,000 and used proceeds to acquire various exempt assets; court confirmed that the mere conversion of nonexempt assets into exempt assets does not, by itself, establish fraud: “the intent to effect such a transfer is merely the intent to exercise a valid right [i.e., use of an exemption] rather than an intent to defraud;” the court also noted absence of concealment or attempt to mislead creditors and a full disclosure was made to the bankruptcy trustee; further the amount involved was modest and there was no indication that this was less than reasonably equivalent value).

**i. Key Factor(s):** absence of concealment or attempt to mislead creditors; full disclosure to bankruptcy trustee; modest amount involved that was reasonably

equivalent value.

*b. In re Bradley*, 294 B.R. 64 (B.A.P. 8th Cir. 2003) (debtors carved out one-quarter acre as their homestead, and claimed the one-quarter acre as exempt; trustee alleged that because the debtors converted non-exempt assets into the homestead, they were not entitled to claim the homestead as exempt; under the Code, the conversion of nonexempt assets into exempt assets, without more, will not deprive a debtor of the right to claim the exemption to which he is otherwise entitled; the court so held even though substantially all of the debtor's assets were converted and the debtor was insolvent at the time of the transfer).

*i. Key Factor(s):* debtor was concerned about tax obligations that might arise from being released from liability for his personal obligation to a corporation he formed to finance the \$45 million purchase price of a division at another corporation; debtor received advice of counsel that the purchase of exempt property would reduce his tax exposure if he were to obtain a release of the obligations – court found that the advice, and not the intent to defraud his creditors, prompted debtor to purchase the homestead.

#### 9. Prepay taxes prior to filing for bankruptcy relief.

*a. In re Graves*, 609 F.3d 1153 (10th Cir. 2010) (prior to filing for bankruptcy relief, Chapter 7 debtors had irrevocably applied their prepetition tax refund to prepayment of their taxes for the next tax year; turnover of debtor's tax refund was inappropriate because, during the case, debtors were never in "possession, custody, or control" of their contingent reversionary interest in the prepayment of their taxes for the subject year; if, after debtors' tax liability for the next tax year was determined, they were entitled to a refund, trustee was entitled to demand turnover of any amount of such refund attributable to prepetition earnings).

*i. Key Factor(s):* debtors, instead of choosing to receive tax refund, elected to leave those funds on deposit with the United States and apply the overpayment to their future tax liability – election was irrevocable; debtors were never in "possession, custody, or control" of their contingent reversionary interest in the prepayment of their taxes for the subject year; debtors presumably controlled the refund before they made their election to apply it to future taxes, but that control was pre-petition and thus not "during the case" as required by § 542(a).

*b. In re Middendorf*, 381 B.R. 774 (Bankr. D. Kan. 2008) (estimated tax prepayment made by debtors shortly after realizing a profit from sale of stock was supported by

“reasonably equivalent value,” and could not be avoided as constructively fraudulent transfer; tax refund to which debtors were entitled as result of their overpayment of federal income taxes, both as result of wage withholding that occurred both pre- and postpetition and due to debtors’ estimated prepayment of taxes, using prepetition income, had to be allocated between pre and postpetition periods, for purpose of determining what portion of refund was estate property and what portion was debtors’ separate property).

- i. **Key Factor(s):** debtors, at time of this tax prepayment, were facing significant tax liability and obtained dollar-for-dollar credit against that potential liability and a right to refund if their tax debt was ultimately less than what they had estimated; debtors could not know, at time of their estimated tax prepayment, that their deductions would be such as to significantly reduce their actual tax liability.

## VI. IMPERMISSIBLE PRE-BANKRUPTCY ASSET PROTECTION PLANNING

### 1. Engage in fraud directed at specific creditors.

a. *In re Gepfrich*, 118 B.R. 135 (Bankr. S.D. Fla. 1990) (debtor attempted to convert a marital asset (an investment) into an exempt annuity; debtor’s wife sought to enforce her rights under a divorce decree; court denied a discharge because the proceeds, which were converted into exempt property, were obtained from marital assets in which the wife had an interest; In addition, the court looked to the debtor’s conduct of misleading both his wife and the state court as to the availability of funds as well as making gifts to his children of a previous marriage).

- i. **Key Factor(s):** amounts involved; timing; fact that the proceeds were derived from marital assets the wife had an interest in; misleading wife and state court as to the availability of the certificate of deposit; and insolvency of the debtor.

### 2. Convert borrowed funds and assets relied on by creditors.

a. *Matter of Armstrong*, 97 B.R. 565 (Bankr. D. Neb. 1989) *subsequently aff’d*, 931 F.2d 1233 (8th Cir. 1991) (debtors encumbered certain property to assist a related party to generate cash that was used by debtors to acquire exempt property; in denying discharge, the Bankruptcy Court stated that “if a debtor was only ‘looking to his future wellbeing,’ a discharge would be granted but if the debtor had a particular creditor in mind in trying to remove his assets from that creditor’s reach, then a discharge would be denied”).

- i. **Key Factor(s):** family relationship between the parties; the retention of posses-

sion, benefit or use of the property; insolvency of the debtor; intent to hinder, delay or defraud creditor (transfers of property occurred after debtors were aware of bank's imminent lawsuit).

**3. Convert business assets.**

*a. In re Collins*, 19 B.R. 874 (Bankr. N.D. Fla. 1982) (on the eve of bankruptcy, debtor transferred \$55,000 from his business resources and converted the funds into homestead property; Court held that conversion was improper; in commenting on the propriety of converting nonexempt assets into exempt assets, the court noted the following "Some transfers [that accomplish a conversion of nonexempt to exempt property] certainly are permissible and should be encouraged. However, in cases with a factual scenario which reveal that business assets which belong to creditors are being used to delete individual debts will not be permitted").

*i. Key Factor(s):* debtor's transfer and omission from schedules of transfer of \$55,000 of business resources to satisfy mortgage on debtor's homestead; timing of the transfer on the eve of bankruptcy.

**4. Spend money so that it does not fall into the hand of creditors.**

*a. In re Rice*, 109 B.R. 405 (Bankr. E.D. Cal. 1989) (denial of discharge where bankruptcy counsel advised debtor to draw as much money as he could from his bank account and spend it, and debtor did so, including transfer of funds to mother who resided with him).

*i. Key Factor(s):* transfer of property of the debtor, within one year before the date of the filing of the petition, with actual intent to hinder and delay a creditor and the bankruptcy trustee; advice from counsel to "spend" the money in this case was unaccompanied by any advice about legitimate exemption planning and about the risks of improper transfers; and transfer to mother was not revealed on the schedules.

*b. In re Lubin*, 61 B.R. 511 (Bankr. S.D.N.Y. 1986) (funds transferred to a child in order to pay for a trip to Europe and to pay child's automobile loan held to be fraudulent transfer resulting in denial of discharge).

*i. Key Factor(s):* family relationship between the parties; transfer of property of the debtor within one year before the date of the filing of her petition with actual intent to hinder, delay or defraud her creditors; debtor knowingly and fraudulently made a false oath.

**5. Prepay domestic support obligations.**

*a. Matter re Swift*, 3 F.3d 929 (5th Cir. 1993) (debtor's transactions with relatives sufficient to deny discharge; debtor's transactions included prepaying alimony to ex-wife, transferring insurance policies to son who, after borrowing against them, transferred funds back to ex-wife who then loaned funds back to debtor who gave her promissory note day before bankruptcy, and borrowing money from daughter in exchange for promissory notes secured by debtor's interests in personal property).

**i. Key Factor(s):** the family relationship between the parties; debtor transferred, concealed, or disposed of property within one year before filing with intent to hinder, delay, or defraud creditors.

**6. Purchase exempt property as a means of temporarily protecting funds.**

*a. In re Johnson*, 124 B.R. 290 (Bankr. D. Minn. 1991) (debtor was denied discharge where he liquidated various nonexempt business investments and used part of the proceeds to purchase minor amounts of exempt whole life insurance and converted certain personal property into exempt musical instruments with the intent of realizing the cash value of the exempt property after bankruptcy proceeding).

**i. Key Factor(s):** debtor never had an intent to use the life insurance policy to maintain insurance coverage on his life for the indefinite future; trading of non-exempt personalty for harpsichord and baby grand piano which he also claimed as exempt under Minnesota law, showed that debtor acted with intent to hinder, delay, and defraud creditors.

*b. In re Preston*, 233 B.R. 375 (Bankr. E.D. Tex. 1999) (relying on policy to prevent parking of assets, no exemption was allowed for burial plots where there was no explanation as to why it was reasonable for the debtor to claim more than one burial plot as exempt).

**i. Key Factor(s):** no explanation why debtor needed four separate burial plots or as to persons for whom other three plots were being held; by eliminating term "family" from exemption statute, Texas legislature intended to broaden exemption to allow debtors to exempt plots not intended for burial of immediate family members, but not to create unlimited exemption.

**7. Convert nonexempt assets into exempt assets for parking purposes.**

*a. In re Zouhar*, 10 B.R. 154 (Bankr. D.N.M. 1981) (discharge was denied when a debtor

converted funds into exempt annuities and insurance policies on the grounds that the debtor had no interest in the annuity for a retirement or insurance purpose).

- i. **Key Factor(s):** debtor forthrightly admitted that he had no interest in the annuity for any retirement or insurance purpose; debtor utilized this method as a device to shield his assets from his creditors.

**8. Park property with an accommodating party.**

- a. *In re Lafferty*, 469 B.R. 235 (Bankr. D.S.C. 2012) (denial of homestead when debtors first transferred homestead to their paramours “with the wrongful intent to defraud” a creditor and avoid its judgment, then recovered the property after debtors “realized that the transfer would not benefit them”).

- i. **Key Factor(s):** debtors were not truthful in bankruptcy proceedings; property transferred to debtors’ paramours for no consideration and with the wrongful intent to defraud a creditor and avoid its judgment; once debtors realized that the transfer would not benefit them they requested that the property be transferred back to them so they could obtain homestead exemptions when they filed their bankruptcy petitions.

**9. Unreasonably exercise exemption.**

- a. *In re Englander*, 156 B.R. 862 (Bankr. N.D. Fla. 1992), *aff’d*, 95 F.3d 1028 (11th Cir. 1996) (debtors had a little more than an acre of land and sought to configure the exemption so that the remainder of the land could not be used because they could only exempt one-half acre – court held that the configuration was not reasonable in that it prevented all access to the other portions of the land except by helicopter).

- i. **Key Factor(s):** debtors attempt to limit the amount of assets available for distribution to their creditors by first misidentifying the size of their homestead and later partitioning the tract containing his residence in such a manner as to render the nonexempt portion of that tract valueless.

**10. Acquire title to a house for no other reason than to defraud creditors.**

- a. *In re Sholdan*, 217 F.3d 1006 (8th Cir. 2000) (debtor was a retired farmer, ninety years of age, afflicted with serious medical problems, and had been recently named a defendant in a personal injury suit with claimed damages well in excess of his liability insurance coverage; court upheld a lower court finding that purchase of a residence was a fraudulent transfer where debtor moved out of an assisted care facility and purchased a home for approximately \$135,000 and, after the purchase of the house, the debtor’s

total income was reduced to \$486 per month; court stated: “[i]t is one thing to convert nonexempt assets into exempt property for the purpose of holding it as a homestead and thereby putting the property beyond the reach of creditors...however, it is quite another thing to acquire title to a house for no other reason than to defraud creditors”).

1. **Key Factor(s):** evidence extrinsic to the mere conversion of assets that showed fraudulent intent on the part of the debtor; court’s refusal to allow homestead right to operate as a vehicle for fraud and rank injustice.

#### 11. Secretly convert nonexempt property into exempt property postpetition.

- a. *In re Koss*, 319 B.R. 317 (Bankr. D. Mass. 2005) (postpetition conversion of significant nonexempt insurance proceeds that belonged to the bankruptcy estate may result in denial of exemption where debtor did so intentionally and in secret).
  - i. **Key Factor(s):** debtor intentionally concealed estate property; debtor failed to deposit insurance proceeds – after a fire destroyed residence and all personal property therein – into the Chapter 11 debtor in possession bank account, report insurance proceeds to the Court, or include the insurance proceeds in his reports to the UST.

#### 12. Overfund retirement plan in violation of IRS/IRC rules.

- a. *In re Rucker*, 570 F.3d 1155 (9th Cir. 2009) (debtor secretly funded plans using a wholly owned offshore corporation and a foreign bank account and one of the plans purchased property on which the debtor resided rent free; the court concluded that debtor used the plans to shield assets from creditors rather than for retirement purposes).
  - i. **Key Factor(s):** debtor consistently funded plans in excess of the contribution limits imposed by the IRC; debtor secretly contributed money to his plans using a wholly owned offshore corporation and a foreign bank account; underreporting of amount of money contributed to plan; debtor’s admission that he never intended to pay another cent on creditor’s “black hole” judgment.

#### 13. Claim an exemption on an amended petition in bad faith.

- a. *In re Wunderlich*, 369 B.R. 80 (Bankr. D.N.H. 2007) (debtor’s bad faith in claiming New Hampshire exemptions, which prejudiced creditors, prevented him from amending petition to claim New York exemptions).
  - i. **Key Factor(s):** debtor repeatedly maintained throughout 341 meeting and

Rule 2004 examination that he did not reside in New York; debtor undervalued his retirement plan; there were potential benefits to claiming New Hampshire exemptions, court had previously denied debtor's discharge because of his bad faith concealment of mortgage proceeds.

**b. *In re Hannigan*, 409 F.3d 480 (1st Cir. 2005)** (the Court may deny the amendment of exemptions where the amendment would prejudice creditors or where the debtor has acted in bad faith or concealed assets).

**i. Key Factor(s):** debtor intentionally undervalued his property in documents submitted to trustee, which consisted of a 1.36-acre house parcel and an adjoining 33-acre parcel; debtor had acted in bad faith in initially valuing, at only \$135,000, homestead property that he later sought to claim as exempt, in proposed amendment to his exemption schedules, in amount of \$300,000; debtor testified that he knew that the information provided to the trustee was not what she had requested and yet did nothing to fix the problem or even bring it to the trustee's attention.

**c. *In re Akulova*, 407 B.R. 602 (Bankr. D. Del. 2009)** (court denied debtor's attempt to amend exemption schedule to include exempt personal injury award when trustee relied on debtor to prosecute personal injury claim; court characterized debtor's conduct as bad faith since she failed to disclose the claim and sought to claim the exemption only after the trustee expended resources to liquidate the claim).

**i. Key Factor(s):** trustee, in reliance on fact that debtor had not claimed exemption in her prepetition personal injury claim, had retained debtor's personal injury attorney as special counsel and successfully prosecuted personal injury claim to settlement on what trustee believed to be creditors' behalf.

**d. *In re Barrows*, 408 B.R. 239 (B.A.P. 8th Cir. 2009)** (bad faith misrepresentation of balance in bank account as \$325, when the actual amount was enhanced by \$17,000 loan from debtor's 401(k) plan, minus certain expenditures, justified court's denial of an attempt to amend his exemption to claim the increased amount in the bank account as exempt).

**i. Key Factor(s):** debtors' failure to accurately disclose the amount of funds in their bank accounts and then asserting an exemption therein only after the trustee demanded turnover of the funds in excess of the originally disclosed amount; evidence that debtors provided inaccurate schedules and statements and that they subsequently failed to correct the material falsehoods therein.

*e. In re Bauer*, 298 B.R. 353 (B.A.P. 8th Cir. 2003) (“the Debtors were not truthful in their disclosures with respect to their home. They substantially undervalued their home in schedules signed under penalty of perjury to reflect no equity. The irony here is that if the Debtors had accurately disclosed the true value of their home from the outset, they may have been entitled to exempt their equity in it. For the price of accurate disclosure, they might have obtained an unencumbered fresh start and retained the equity in their home”).

- i. Key Factor(s):** debtors were not truthful in their disclosures with respect to their home – substantially undervalued their home in schedules signed under penalty of perjury to reflect no equity; only amended their schedules to increase the value of the home after the trustee had learned of its true value following the fire and accompanied their belated updated disclosure with a bad faith attempt to assert a homestead exemption.

**14. Use fraudulently obtained funds to obtain exempt property.**

*a. Chiu v. Wong*, 16 F.3d 306 (8th Cir. 1994) (debtor wrongfully terminated a partnership and deprived his partner of rights in specific partnership property; to the extent the funds were used to purchase the homestead, the exemption would be denied and a constructive trust or implied trust imposed).

- i. Key Factor(s):** Lai’s wrongful conversion of partnership assets; Chiu sufficiently traced the proceeds of his partnership property into Wong’s homestead.

*b. Palm Beach Sav. & Loan Ass’n v. Fishbein*, 619 So. 2d 267 (Fla. 1993) (creditor can have an equitable lien on property, such as when fraudulently obtained property – loan obtained after husband forged wife’s signature on loan documents – was used to purchase a homestead).

- i. Key Factor(s):** husband’s forgery of wife’s signature on loan documents.

*c. Casterline v. Roberts*, 284 P.3d 743 (Wash. App. Div. 2 2012) (“homestead protection does not extend to equitable liens imposed when the homestead claimant purchases the homestead property with wrongfully obtained funds; “defendant wrongfully took money from a trust and attempted to shield those funds in a homestead).

- i. Key Factor(s):** trustee’s violation of fiduciary duty by investing trust funds in home which did not benefit the trust and then wrongfully transferring the property to husband.

**VII. CONCLUSION**

As the cases above illustrate, the effective use of state and federal exemptions coupled with prompt and complete disclosure is an excellent strategy that debtors use to protect their assets from being seized by creditors. However, debtors and debtors' attorneys must take extra care to ensure that prebankruptcy asset protection planning does not include fraudulent transfers or acts that otherwise hinder, delay, or defraud their creditors. To best create a clear picture of a debtor's financial condition, the New Client Checklist provided in the Appendix is a great tool that is ideally utilized when you first sit with a client to discuss their options before filing for bankruptcy. If you have any questions about pre-bankruptcy planning, or reorganization and bankruptcy in general, please do not hesitate to contact Barbara Yong of Golan & Christie LLP by phone at (312) 696-2034 or email at [blyong@golanchristie.com](mailto:blyong@golanchristie.com).

# AMERICAN BANKRUPTCY INSTITUTE

## APPENDIX NEW CLIENT CHECKLIST

### 1. Introduction

- Be thorough; review paperwork
- Ask client to complete intake questionnaire
- Insist on full disclosure (§526(a)(2) – Attorney reasonably should have known)
- Review non-bankruptcy alternatives
- Understand circumstances, i.e.
  - marital status/divorce
  - employment status/prospects
  - residence/mortgage debt
  - business debt/guaranties, wages, union dues
  - tax debt – income, sales or employee withholding (how old)
  - student loans – government or private, how old, hardship
  - credit cards – interest rates, business or personal use
  - residency for last 3 years
- Let client know what you will and will not be able to do for them, what is included in flat fee and what will be billed separately
- If retained, get signed engagement letter

### 2. Assets

- Get a complete list
- Transfers within the past 4 years, outside ordinary course of business
- Transfers within the past 10 years to a self-settled trust
- Causes of action
- Possible future inheritances
- Valuation – reasonable basis
- Owned individually or jointly
- How is title held, i.e. tenancy by the entireties (Only effective if H&W, residence, not joint debt), joint tenancy, tenants in common
- Understand exemptions
  - homestead
  - life insurance
  - qualified retirement accounts (inherited IRA's not exempt)
  - vehicle
  - wildcard
  - tools, supplies
  - clothes
- Cash/savings – possible uses
  - Warn about potential preferences; fraudulent transfers
  - pending lawsuits or potential claims
  - ownership interest in businesses
  - Remove name from joint accounts if co-signer for convenience only, i.e. elderly parent or child

### 3. Liabilities

- Dischargeable vs. non-dischargeable

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- fraud
- student loans
- taxes (income taxes more than 3 years old)
- support vs. property settlement (ch. 7 neither support nor property settlement are dischargeable, but in ch. 13 - §1328(a)(2) only excepts DSO from discharge - §523(a)(5) not (a)(15))
- Under §1328(a) certain debts can be discharged in ch. 13 notwithstanding that they are not dischargeable in ch. 7 under §523(a)(6), (7) and (10) through (19)
- Disputed/consider litigating
- Attempt modification
- Negotiate settlement or payment plan
- Pay down highest interest credit cards
- Student loans – hardship exemption
- Reaffirmation or surrender
- Consider ramifications on co-debtors

### 4. **Income**

- For chap. 13 plan or means test
- Get documentation
- Abuse defined under §707(b)(2) and (b)(3)
- Income from employment
- Income from other sources
  - rental income
  - unemployment
  - social security/disability/pension
  - dividends and distributions
  - support and maintenance