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American Bankruptcy Institute Law Review
Volume 6 Number 1 Spring 1998

DISTINGUISHING HOGS FROM PIGS: A PROPOSAL FOR A PREFERENCE APPROACH TO PRE–BANKRUPTCY PLANNING

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I. INTRODUCTION

Outside of bankruptcy, there is nothing wrong with preferring one creditor over another. [1] We pay our mortgage loans so that we do not lose our houses, our car loans so that we have a means of transportation, and our utility bills so that we do not lose heat and electricity. When the balances in our checking accounts get a little low, we might let a credit card bill slide, knowing that the only immediate repercussion might be a late fee. Each creditor's leverage plays a role in when and how much the creditor is paid.

When the proverbial noose of the creditors begins to tighten, the Bankruptcy Code of 1978 (the "Code") [2] and state debtor–creditor laws constrain debtor behavior in several different ways, each constraint aimed at deterring debtors from depriving creditors of assets. In furtherance of this aim, state and federal laws allow creditors to avoid fraudulent transfers of a debtor's property [3] and the Code allows a trustee in bankruptcy to set aside preferential transfers, those pre–bankruptcy transfers of the debtor's property which result in one creditor receiving more than it would if it had waited until the bankruptcy distribution for payment. [4]

State and federal laws also protect the debtor when the noose begins to tighten. The Code and state law protect some of an individual debtor's property from creditor process through exemption laws. [5] Prior to the enactment of the Code, Congress debated whether the Code should mandate uniform federal exemptions for debtors who choose the protection of the Code. [6] The Code reflects a compromise, under which states can opt–out of the federal exemption scheme and require debtors located in those states to use the state exemptions. [7] Thirty–five states have opted out of the federal exemption scheme, [8] resulting in a tremendous range of property that debtors throughout the country can keep after a chapter 7 case. [9]

One type of debtor behavior that is not explicitly forbidden by the Bankruptcy Code and which is the subject of a patchwork treatment by the courts is the practice of converting non–exempt property to exempt property on the eve of bankruptcy. [10] Such conversions, which result in the depletion of the debtor's estate available to creditors, [11] do not fit neatly within the proscriptions of the statutes dealing with fraudulent transfers and preferential transfers. [12] There appear to be several reasons for the diversity of opinions on the issue. Among them are the two different types of actions that creditors typically bring, (actions to disallow the exemption and actions opposing the debtor's discharge [13]) and the wide range of state exemption statutes.

Uniformity in the arena of pre–bankruptcy planning is desirable for several reasons. Perhaps most importantly, the availability of bankruptcy law's debtor protections, such as the discharge, [14] should be a question of federal, not state, law. Also, the conversion of non–exempt to exempt property serves to deprive the debtor's unsecured creditors and to the extent that courts in different parts of the country apply different standards to conversions, creditors in different parts of the country are treated differently. [15] In addition, attorneys advising their clients prior to bankruptcy are hindered in giving advice by the non–uniformity of treatment of the issue. [16]

In this article, I argue that courts should not look upon pre–bankruptcy exemption planning as a fraudulent transfer issue, but rather as a preferential transfer issue. Part II of this article will discuss the need for a

coherent theory, Part III will discuss some of the recent pre–bankruptcy planning cases, Part IV will discuss why uniformity in the area of exemption planning is desirable, Part V will discuss some of the scholarly analysis of pre–bankruptcy exemption planning, Part VI will discuss exemption policy generally, Part VII will discuss the preference avoidance power, and Part VIII will propose a statutory treatment of pre–bankruptcy exemption planning patterned on the Code's preferential transfer provision.

II. THE NEED FOR A THEORY

Bankruptcy law has two important goals: that of a fresh start for an individual debtor [17] and that of the equal treatment of creditors. [18] Exemption laws further the former goal [19] and the trustee's powers to avoid preferential transfers and fraudulent conveyances further the latter. [20] Certain provisions of the Code, such as the automatic stay, [21] are directed at preserving the estate for the debtor's creditors, so that all can share according to their priorities in bankruptcy. [22]

When courts, legislators and scholars point to provisions that seek to preserve the estate for the benefit of creditors, however, they find primarily Code provisions designed to discourage debtors from transferring their property away from themselves and to creditors (in the case of preferential transfers) [23] and to third parties other than creditors (in the case of fraudulent transfer laws). [24] There is nothing in the Code specifically designed to discourage the debtor from essentially making a "transfer" of property to himself — from his pool of non–exempt property to his pool of exempt property. The effect of such a transfer, however, is the same as the effect of a preferential transfer: it allows one creditor, the post–bankruptcy debtor, to receive more than it would in a chapter 7 liquidation, while diminishing the amount of property available for the general unsecured creditors. [25]

A preference analysis would avoid some of the problems inherent in the current approaches to pre–bankruptcy planning. One reason for the lack of uniformity in the approaches to pre–bankruptcy planning is that the creditors and the trustee in bankruptcy have a choice of actions to bring against the debtor. [26] A creditor can object to the debtor's discharge under section 727(a)(2) of the Code, which states that the court shall grant the debtor a discharge unless the debtor, with intent to hinder, delay or defraud a creditor, has transferred his or her property within one year before the date of filing the petition in bankruptcy. [27] A creditor can also challenge the debtor's right to claim the exemption either under the Code [28] or under the applicable state's law. [29] Creditors have also looked to set aside such conversions as fraudulent transfers under section 548 of the Code. [30] Some courts have noted that a creditor or the trustee could move to have the case dismissed for cause or substantial abuse under section 707. [31]

In many cases, courts hold that the debtor is entitled to take full advantage of his state's exemptions. [32] The effect is that a debtor is allowed to keep property acquired immediately before bankruptcy whether or not the debtor needed such property before the prospect of bankruptcy appeared on the horizon. The result is to favor those debtors who have a large number of non–exempt assets on the eve of bankruptcy and disfavor those who do not. It is very possible that in both scenarios, the end result in bankruptcy could be the same: no assets for unsecured creditors. Once again, the policy of encouraging repayment is thwarted. So long as the asset–rich debtor has not done anything that would fall into the section 707 proscription on abuse of the bankruptcy process, the asset rich debtor can file under chapter 7 and pay his creditors the same percentage of his debts as the asset poor debtor can.

The preference analysis avoids all judgments about a state's exemption laws. The question of the need for uniformity in exemptions has recently been debated by the National Bankruptcy Review Commission (the "Commission"). [33] The result of the debates prior to the Code's enactment was the opt–out. [34] The Commission proposed elimination of the opt–out, a range within which the homestead exemption can fall and a lump sum personal property exemption, an approach that would all but eliminate the exemption planning problem. [35] However, there is no guarantee that Congress will adopt the Commission's proposals. Even if states have an interest in providing exemptions for debtors residing within their borders, [36] because of the unique attributes of bankruptcy law, Congress has an interest in assuring that there is a federal exemption policy, and a preference approach to pre–bankruptcy planning would further such a policy.

Some state exemption statutes incorporate a preference approach. Several states exempt retirement plans in an unlimited amount. [37] Clearly, such states want to encourage their citizens to save for retirement. [38] Some states have prohibited debtors from contributing large amounts to their retirement plans on the eve of their bankruptcy filings. Pennsylvania has incorporated a preference element into its exemption statute, disallowing an exemption for contributions made within a year before the bankruptcy filing, [39] and Arizona's exemption statute denies an exemption for contributions made within 120 days before the filing. [40] New York has also incorporated a preference approach in its exemption statute, limiting an exemption for annuities to $5,000 if the annuity was purchased within six months before the debtor's petition in bankruptcy. [41]

The major advantage of a preference approach would be uniformity, which results in the equal and fair treatment of both debtors and creditors. Another advantage of a preference approach would be to eliminate costly litigation regarding transfers made within a certain time period before the bankruptcy filing. The door would still be open to allegations of fraud and a debtor could be denied a discharge if the debtor's behavior was egregious. Under the preference approach all transfers made within the preference period and otherwise satisfying the elements of a preference would be avoidable, with the result being the denial of the debtor's exemption, a far less harsh remedy than the denial of a discharge. In addition, a preference approach would give some comfort to lawyers advising their clients on the eve of a bankruptcy filing. [42]

III. THE STATE OF THE CASE LAW

The judicial approach to pre–bankruptcy planning reflects a great amount of uncertainty. Such uncertainty is due, in part, to the two different types of actions typically brought by creditors who challenge asset conversions, objections to discharge, [43] and objections to exemptions. [44] The debtor who unsuccessfully challenges the objection to discharge is subject to a drastic penalty; he or she keeps the exempt property but emerges from bankruptcy owing all prepetition debts. [45] The debtor who unsuccessfully challenges the objection to exemptions receives the discharge, but loses the allegedly exempt property to creditors. [46] The cases show the perpetual pull in bankruptcy between federal and state law, since when a debtor claims a state–created exemption, the scope of the claim is determined by state law, while the debtor's right to a discharge is governed by federal law. [47]

When a trustee in bankruptcy or a creditor challenges a debtor's right to acquire exempt property shortly before bankruptcy, the courts scrutinize the debtor's sale of non–exempt property. [48] It is the cash from this sale that is used to acquire the exempt asset. [49] In cases where there is no sale of property, the courts scrutinize the debtor's use of non–exempt cash to purchase an exempt item of property. In almost all cases, proof of the debtor's fraudulent intent in selling the non–exempt asset or using the non–exempt cash is necessary for the creditor or trustee to prevail. [50] The Code requires an intent to "hinder, delay or defraud" [51] a creditor for the debtor to be denied a discharge under section 727 and the Code's fraudulent transfer provision, section 548, requires either actual intent to "hinder, delay or defraud" [52] a creditor or constructive fraud in order for a transfer of a debtor's property to be set aside as fraudulent. [53] Although there is nothing in section 522, the Code's section governing exemptions, regarding fraudulent intent, [54] courts nevertheless apply a fraudulent transfer standard when determining whether to allow a debtor to claim an exemption. [55] There is an important limitation on the courts' willingness to find fraudulent intent in many cases, since a debtor's fraudulent intent in these cases is almost always limited by the principle 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 allowed." [56]

In finding fraudulent intent, courts have fashioned a variety of tests that vary in their clarity. *First Texas Savings Ass'n v. Reed* (*In re Reed*) [57] illustrates the federal/state pull inherent in these cases by allowing the debtor to keep his exemptions but denying the discharge. The court took pains to distinguish actual intent to defraud creditors from "the intent to put assets beyond the reach of creditors, which is, after all, the function of an exemption . . . ." [58] Mr. Reed bought guns, antiques, coins and corporate stock, some of which he sold for fair market value and some of which he sold for values not determined to be fair or unfair. [59] With the proceeds, he paid $45,000 to reduce the mortgage indebtedness on his homestead. [60] All of the transactions

took place within two weeks of the debtor's chapter 7 filing. [61] The court found the debtor's fraudulent intent in the debtor's whole pattern of conduct, his rapid conversion of his assets, and the fact that he diverted some of his money into a secret bank account. [62]

In searching for the debtor's fraudulent intent in determining whether to deny either the discharge or the exemption, courts tend to weigh certain badges of fraud. [63] Courts use these badges of fraud, or extrinsic evidence of fraud, because fraudulent intent is difficult to prove directly. [64] The classic badges of fraud are listed in the Uniform Fraudulent Transfer Act ("UFTA") and include transfers to an insider of the debtor, concealed transfers, transfers made after the debtor had been sued, transfers made while the debtor was insolvent or shortly before the debtor became insolvent, transfers for less than a reasonably equivalent consideration, and transfers of substantially all of the debtor's assets. [65]

The problem with using the badges of fraud is that one of them is rarely present in the pre–bankruptcy planning cases in that most of the sales of non–exempt property are for a reasonably equivalent value, and several of the badges are often present. [66] One of the badges of fraud is that the transfer was made after the debtor had been sued or threatened with suit. [67] This is a badge of fraud because a creditor with a judgment against a debtor can obtain rights in the debtor's property. The effect of filing a bankruptcy petition is the same in that once a bankruptcy petition is filed, all of the debtor's property goes into the estate for the benefit of creditors. [68] For at least one court, however, the fact that a creditor had obtained a $103,092 judgment shortly before the debtor's bankruptcy filing was dispositive in the court's decision to deny the debtor's claim of an exemption in roughly $210,000 of property. [69] This may seem at odds with the general rule noted earlier that conversion of assets with the express purpose of placing property beyond the reach of creditors is insufficient to deny a debtor an exemption, but that case, *In re Schwarb*, holds that such a conversion is sufficient to deny a debtor the right to claim an exemption. [70]

Another badge of fraud is that the transfer was of all or substantially all of the debtor's assets. [71] The UFTA defines "asset" as the debtor's property except for property exempt under non–bankruptcy law. [72] Since the effect of a pre–bankruptcy conversion of non–exempt to exempt property is often the near total depletion of the estate available to creditors, this badge is also present. [73] Again, however, as noted above, most courts hold that conversion of non–exempt to exempt property for the purpose of placing such property beyond the reach of creditors, by itself, will not deprive the debtor of his exemptions. [74] The result is a hodgepodge of judicial approaches with the fact that a debtor used all of his or her non–exempt property to acquire exempt property considered important in some cases and nearly irrelevant in others, even in cases involving identical amounts of property transferred. [75] In *Albuquerque National Bank v. Zouhar* (*In re Zouhar*), [76] a case decided under the Bankruptcy Act of 1898 (the "Act"), the court's decision to deny the debtor a discharge was based primarily on the fact that all of his property was involved and the property converted would have been sufficient to pay all of the debtor's debts. [77] That court's exemption policy was stated as follows, "[w]hile a bankrupt is entitled to adjust his affairs so that some planning of one's exemptions under bankruptcy is permitted, a wholesale sheltering of assets which would otherwise go to creditors is not permissible." [78]

Some courts look to the amount of the property transferred as the dispositive factor, with one court saying that the "bankruptcy court has the primary duty to distinguish hogs from pigs." [79] An interesting illustration is provided by an analysis of two cases decided by the Eighth Circuit on the same day, *Hanson v. First National Bank in Brookings*, [80] a case in which a creditor unsuccessfully objected to the debtor's exemptions, and *Norwest Bank Nebraska v. Tveten* (*In re Tveten*), [81] a case in which a creditor successfully objected to the debtor's discharge. In *Hanson*, the debtors, who were farmers, sold non–exempt property worth roughly $31,000 and used the proceeds to purchase exempt life insurance policies with a combined cash surrender value of $19,955, and prepay their home mortgage loan. The South Dakota exemption law permitted debtors to exempt a homestead without limitation and up to $20,000 of the proceeds of life insurance policies. [82] In *Tveten*, the debtor, a physician, sold almost all of his non–exempt property and purchased $700,000 worth of exempt life insurance and annuity contracts. [83] At the time, Minnesota law provided for an unlimited exemption in annuity contracts payable by a fraternal benefit society. [84]

As these cases were decided by the same court on the same day, it is not surprising that they contained similar reasoning. First, in both cases, the court looked to the traditional badges of fraud and noted that converting assets prior to bankruptcy, without more, does not show fraudulent intent. [85] In both cases, the property in both cases was sold for fair market value, lack of which is a traditional badge of fraud. [86] Finally, title and possession to both properties sold appeared to have been transferred properly. [87] In *Hanson*, the court found no "extrinsic evidence" of fraud, while in *Tveten*, it did. [88]

The primary difference between the two cases was the amount of property transferred, a point made by the concurring opinion in *Hanson*. [89] In both cases, the debtor did exactly what the state law permitted, but in South Dakota the exemptions had dollar limits, while in Minnesota they did not. [90] An important point about the *Tveten* case is that the court makes a judgment about the appropriateness of the respective state exemption laws using its own conception of what is "necessary." [91] The court explained the purposes of exemption statutes and found that Dr. Tveten's behavior went well beyond conforming with those purposes. [92] The court appears to discourage unfettered exemption planning in states that do not have dollar limits on categories of exempt property, noting those state laws that include limits on the value of exempt property are consistent with the federal policy in favor of allowing the debtor to make a fresh start. [93]

Debtors who have attempted to exempt far less than $700,000 have been denied either the exemption or the discharge. [94] The purposes behind exemption statutes were important to the court's reasoning in *Zouhar*, a case in which the debtor, who was also a physician, exempted less than $50,000 of previously non–exempt property by selling stock in his professional corporation and bought an exempt annuity. [95] The applicable New Mexico statute exempted annuities without limit. [96] He also bought a home and prepaid his son's tuition in the amount of $1860. [97] The debtor earned approximately $70,000 a year, was recently divorced, and the result of a discharge would have been freedom from his divorce obligations [98] and a remaining net worth of $130,000. [99] The Act had a section analogous to section 727(a) of the Code, which denied a discharge to a debtor who transferred his property with the intent to hinder, delay, or defraud his creditors. [100] The court denied the discharge, holding that the tuition prepayment and the mortgaging of stock to purchase an exempt annuity was fraudulent transfers. [101]

The *Zouhar* court used much of the jargon commonly found in the pre–bankruptcy planning cases. [102] The court was concerned that allowing an exemption in this case would constitute an abuse of the bankruptcy process in that the debtor did not desire a fresh start, but a head start. [103] Like the court in *Tveten*, this court saw an unlimited potential for abuse in exemption statutes that do not have monetary limits, and noted that cases that permitted pre–bankruptcy conversions of non–exempt to exempt property "generally involved considerably smaller sums than are involved here." [104] The court found the debtor's intent to defraud in the fact that the debtor was motivated not by the purpose for which the New Mexico legislature enacted the exemption statute, long–term protection for the debtor and his family against death, disability or retirement, but by the purpose of self–induced insolvency in order to shelter assets from the bankruptcy trustee. [105] While most courts say that the debtor's desire to shelter assets from creditors does not constitute fraud in itself, Dr. Zouhar was candid in his admissions that he was trying to keep assets from the trustee. [106]

More than one court has cited the adage, "when a pig becomes a hog, it is slaughtered." [107] However, in the high exemption state of Florida, commonly characterized in the media as a "debtor's paradise," [108] an elderly debtor couple who purchased a $14,000 annuity five days before filing for bankruptcy was denied a chapter 7 discharge in *Crews v. First Colony Life Insurance Co.* (*In re Barker*). [109] The Florida exemption statute exempted annuity policies without a value limit. [110]

Unlike the court in *Tveten* and *Hanson*, which used the financial position of the debtors before and after bankruptcy to formulate extrinsic evidence of fraud, the court in *Barker* took note of, but gave no weight to, the fact that both of the debtors were living on Social Security payments. [111] They purchased the annuity policies eleven days after they were sued for a deficiency judgment following the repossession of their mobile home. [112] The debtor husband admitted that he purchased the annuity policy in a "desperate attempt to save the last of [their] savings," as he and his wife had no other assets to live on during his retirement years. [113]

Leniency toward the homestead exemption is another theme running through the cases. A year after deciding the *Tveten* and *Hanson* cases, the Eighth Circuit was faced with the bankruptcy of one of Dr. Tveten's real estate partners in the case of *Panuska v. Johnson* (*In re Johnson*). [114] This debtor had sold various assets, all for apparently adequate consideration to pay off $175,000 worth of debts secured by his exempt homestead and purchase annuities and IRAs in the amount of nearly a quarter of a million dollars, [115] life insurance policies worth $4,000 and musical instruments worth $8,000. [116] The court remanded the case for a finding of extrinsic evidence of fraud with the guidance of a test fashioned from the court's reasoning in *Tveten* and *Hanson*, illustrating the rule by example rather than setting forth fraudulent intent. [117]

The *Johnson* court makes an interesting distinction between the homestead exemption and other exemptions. Although the Eighth Circuit, in formulating its test to determine whether the conversion of non–exempt to exempt assets should be permissible, retained the value of the property converted as a factor, the court specifically excepted the homestead from this factor, even in states in which the homestead exemption is unlimited. [118] In making this distinction, the court characterized the homestead exemption as the exemption most central to the legitimate aims of state lawmakers. [119] The court then distilled a test from *Tveten* and *Hanson* and said that "extrinsic evidence [of fraud] can be composed of: further conduct intentionally designed to materially mislead or deceive creditors about the debtor's position; conveyances for less than fair value; or the continued retention, benefit or use of property allegedly conveyed together with evidence that the conveyance was for inadequate consideration . . . [and in] exemptions other than the homestead exemption, the amount of property converted." [120] In formulating the test, the court conceded that "separating ordinary pre–bankruptcy planning from fraudulent action is difficult." [121] It is interesting to note that under this test, a debtor could be denied a discharge if he or she acquired $500,000 in exempt annuities prior to bankruptcy, assuming that they were exempt without limitation under state law, but that same debtor could acquire a $500,000 house under the same circumstances and receive a discharge.

In *NCNB Texas National Bank v. Bowyer* (*In re Bowyer*), [122] the chapter 7 debtor couple withdrew $24,000 from their savings and paid down the mortgage on their homestead approximately fifteen days before they filed their bankruptcy petition. [123] The court, in a case with little reasoning, found that paying down the mortgage constituted legitimate pre–bankruptcy planning. [124] The homestead cases are troubling in light of the fact that debtors undoubtedly need a place to live, but each state's determination of how much home a debtor needs ranges from no home at all in Pennsylvania, New Jersey, Rhode Island, and the District of Columbia, to a home of unlimited value in Texas, Florida, Iowa, Kansas, and South Dakota. [125] This nonuniformity of homestead exemptions has caused some well–situated debtors to relocate before filing for bankruptcy. [126]

In the fraudulent conveyance challenges, the courts are almost unanimous in holding that something more than the debtor's desire to shield assets from creditors is necessary to deny a discharge. [127] However, this is not the case when the debtor moves from one state to another. One year and five days prior to filing for bankruptcy, the debtors in *In re Coplan* [128] moved from Wisconsin to Florida in order to take advantage of Florida's more generous homestead exemption. [129] In ruling that the debtors' specific purpose of shielding their assets from their creditors was sufficient to deny the debtors their exemption, the court based its decision on section 522 of the Code, which says nothing about pre–bankruptcy planning. [130] The creditors and trustee were precluded from relying on section 548, however, because more than one year had passed between the house purchase and the bankruptcy petition. [131] The court that decided *Coplan* appears to look upon all pre–bankruptcy planning with disdain, stating that, "[t]his case is plainly unlike the situation where, following conversion of assets, an unexpected disaster occurs that pushes a debtor into bankruptcy and thus necessitates a different treatment." [132]

Not all courts require that the debtor's intent be fraudulent in order to deny the debtor a discharge. In the *Barker* case discussed above, the trustee challenged the debtors' claim of exemption in annuities worth about $14,000. [133] The court correctly noted that there is nothing in section 522 that would deny the debtors' exemption claim and focused on the proper test to be applied in determining the debtors' entitlement to a discharge. [134] The court considered various factors in searching for "extrinsic evidence" of fraud sufficient to deny a discharge, including whether: the objecting creditor has a "special equity" in the property converted;

the debtor and the transferee had a close relationship; the debtor continued to possess, benefit from or use the property; the debtor engaged in a "sharp practice" of dealing prior to filing for bankruptcy; the debtor became insolvent as a result of the transfers; the conversion occurred after the entry of a judgment or the debtor received inadequate consideration. [135]

Interestingly, the court did not find evidence of fraud in *Barker*. [136] Rather, the court found that the debtors, in failing to list the questionable transfers in their schedules, attempted to hinder or delay their creditors. [137] Since the Code allows the court to deny a discharge to a debtor who attempts to "hinder, delay or defraud" his creditors, the Barkers' discharge was denied. [138]

A final important theme running through these cases is the willingness or unwillingness of courts to substitute their judgments for the judgments of state legislatures in allowing exemptions. The Eighth Circuit showed an unwillingness to do so with respect to homestead exemptions in *Johnson,* [139] but a willingness to do so with other unlimited exemptions in *Tveten*. [140] The problem of unlimited state exemptions was addressed in the case of *Staats v. Beckman* (*In re Beckman*). [141] Under the Ohio exemption statute, which governed in that case, life insurance policies purchased for the benefit of the debtor's spouse, children, dependent relatives or creditors were exempt without a dollar limit. [142] In the statute, an exemption could be denied if the policies were purchased "in fraud of creditors," but the statute did not define that phrase. [143] The debtor husband, two days before the bankruptcy petition was filed, used $15,000 in fees earned in his dental practice to purchase a $100,000 life insurance policy for himself and a $100,000 life insurance policy for his wife. [144]

In holding that the exemption was avoidable, the court analyzed the badges of fraud. One fact the court considered was that the debtor purchased the policies just two days before the bankruptcy petition. [145] The court recognized, however, that this usually occurs in pre–bankruptcy planning cases. [146] The court also looked to the amount of insurance purchased and found that the additional insurance was not necessary for the protection of the debtor's family. [147] In doing so, the court substituted its judgment for that of the Ohio legislature in determining what property is necessary for a debtor to keep after bankruptcy.

While some judges will substitute their judgment for that of state legislatures, others will not. This complicates the question of whether or not bankruptcy law is, or should be, uniform. In *Up State Federal Credit Union v. Carletta* (*In re Carletta*), [148] the debtors, taking advantage of New York's exemption laws, used $7,500 of their non–exempt cash to purchase exempt insurance policies roughly two weeks before filing their chapter 7 petition. [149] In New York, insurance policies were exempt without limit. [150] The creditor sought to deny the debtors their discharge under section 727(a). [151] The court noted that it was unwilling to place a dollar limit on an unlimited exemption, but within limits, stressing that the amount of non–exempt property converted to exempt property is relevant to a determination of whether to deny the debtor a discharge under section 727(a). [152] The same court had noted its approval of New York's $5,000 limit on exemptions for certain annuities a year earlier in *In re Moore*, saying that such a limitation demonstrated "the legislature's intent to balance the debtor's right to a fresh start and limit the debtor's ability to deliberately 'load up' on exempt property." [153]

Clearly, the law that courts apply to pre–bankruptcy asset conversions is not uniform. Part of the non–uniformity stems from the fact that most of the states have opted out of the federal scheme of exemptions, as permitted by the Code. [154] However, since the debtor's entitlement to a discharge is a matter of federal, not state law, such non–uniformity is impermissible as a matter of bankruptcy policy. It is necessary, then, to discuss what uniformity really means for bankruptcy purposes in order to determine the approach that courts and Congress should take to pre–bankruptcy planning.

IV. WHY UNIFORMITY IS DESIRABLE

The Constitution gives Congress the power to enact uniform bankruptcy laws for the United States. [155] Uniformity is desirable for creditors, who receive the benefit of a collective proceeding, and for debtors, who receive the benefits of a discharge. A lack of uniformity leads to unfair treatment. Many creditors, such as banks and retailers, conduct business that crosses state boundaries and would benefit from a uniform rule that

would ensure their fair treatment nationwide. Local creditors would benefit as well, since the current confused treatment of the pre–bankruptcy planning issue allows creditors in some states to fare better than those in others, for reasons that go beyond the non–uniformity of exemptions. Most importantly, the benefits of a discharge should go to debtors who comply with the Code, and the current state of pre–bankruptcy planning laws makes it nearly impossible to determine the meaning of compliance.

Over the course of American bankruptcy history, the term "uniformity" has not been interpreted in a consistent manner. An often cited definition of uniformity comes from the 1902 case of *Hanover National Bank v. Moyses*, [156] where a creditor challenged the Bankruptcy Act of 1898 as unconstitutional because it incorporated state exemption laws and thus violated the uniformity clause. [157] The Court in *Moyses* defined uniformity for bankruptcy purposes to mean geographical uniformity, under which the bankruptcy laws would be considered uniform if, in each state, the trustee takes, inside bankruptcy, exactly what the creditors would take outside bankruptcy. [158] Under *Moyses*, therefore, the Act's scheme of non–uniform exemptions passed constitutional muster.

The *Moyses* conception of uniformity was explained, and perhaps refined, seven years later in the case of *Thomas v. Woods,* [159] a case involving the dower rights of the debtor's wife. [160] The trustee claimed that if each state's laws concerning dower were made applicable in bankruptcy, the law would not be uniform within the Constitution's mandate. [161] The court explained that the uniformity required by the Constitution "relates to the law itself, and not to its results upon the varying rights of debtor and creditor under the laws of the several states." [162] In elaborating on the concept of uniformity, the court pointed to the history and purpose of the Constitution's uniformity clause, which was, in part, to prevent Congress from passing laws that applied to or favored citizens of some states but not others. [163]

The reasoning of *Moyses* and *Thomas* was carried forward into the Code in *Storer v. Thorpe Credit, Inc*., (*In re Storer*), [164] a case involving Ohio's exemption statute, which, by its terms, did not "affect or invalidate any sale, contract of sale, conditional sale, security interest, or pledge of any personal property, or any lien created thereby." [165] The creditor argued that because the debtor had chosen to use Ohio exemptions, its lien, which would have otherwise been avoidable under section 522(f) of the Code, [166] was valid under the state law. The court drew a distinction between an "exemption" and the "operation of liens upon an exemption," stating that no state can pass a law denying a debtor the right to avoid a lien, as authorized by the Code. [167]

The *Storer* case illustrates how federal bankruptcy policy overrides state law even when a debtor chooses, or is forced, to utilize state exemptions. [168] The liens invalidated by section 522(f) are valid, perfected liens under each state's version of the Uniform Commercial Code (the "UCC"). [169] The Code, in section 522(f), reflects a federal policy that creditors should not get the benefit of non–possessory, non–purchase money security interests in certain exempt property. [170] Likewise, the policy against pre–bankruptcy conversion of non–exempt to exempt property should be strong enough to prevail over each state's interest in allowing debtors to exempt certain types of property.

The Commission, in its report completed in October, 1997, recommended eliminating the current system under which states can opt out of the scheme of federal exemptions provided in section 522 of the Code. [171] The commissioners stressed the need for balance in the Code between the objectives of fair treatment for creditors and a fresh start for debtors. [172] The commissioners recognized that the geographic uniformity permitted by *Moyses* works to the detriment of creditors, particularly creditors who operate nationally, in that creditors of financially identical debtors can receive vastly different distributions depending on where the debtors happen to live. [173] In proposing a mandatory set of federal exemptions, the commissioners point to the different bargains struck by debtors who file for bankruptcy protection and debtors who allow creditors to pursue their state law remedies. [174] Without going into much detail, the report points to the automatic stay and discharge as unique attributes of the federal system. [175]

There may be reasons why a state would want to keep its exemption laws and allow a debtor to take advantage of them in bankruptcy. In the debates preceding the enactment of the Code in 1978, there was some sentiment that federal exemptions which were more generous than a state's exemptions would cause debtors to file

bankruptcy petitions, while federal exemptions which were less generous than state exemptions might cause creditors to file involuntary petitions in those states. [176] However, in order to get some of the benefits of a bankruptcy case, there should be some limitations on the debtor's ability to take advantage of such exemption laws.

Bankruptcy is a collective proceeding that gives debtors and creditors advantages that they do not have outside bankruptcy. The successful completion of the collective proceeding gives the individual debtor an advantage he would not enjoy under state law — the discharge of his debts. [177] Preference law, unlike fraudulent conveyance law, has as its basis the preservation of the collective proceeding by adjusting the rights of creditors among each other, while fraudulent conveyance law adjusts the rights of creditors vis–à–vis the debtor. [178] When a debtor makes a pre–bankruptcy transfer of non–exempt property to purchase exempt property, the effect is both to harm individual creditors and to thwart the collective proceeding. The collective proceeding is thwarted because the debtor, who is last on the distribution priority list, elevates himself to first place. [179]

Uniformity in the approach to pre–bankruptcy planning is desirable because of the benefits that a debtor receives from a collective proceeding. Since the availability of the discharge is a matter of federal law, there must be some uniformity in application of the Code. A uniform approach to exemption planning does not interfere with the idea that state laws govern property rights in bankruptcy, [180] since states can keep their exemption provisions and those provisions can be respected in bankruptcy. [181]

V. THE EXISTING THEORIES

Since the enactment of the Code, several commentators have attempted to fashion a reasoned approach to the pre–bankruptcy asset conversion issue. Some view the right to exemptions as a property right that must be respected in bankruptcy, [182] others adhere to the fraudulent transfer approach, [183] while others advocate a bar date approach, which takes into account the debtor's need to keep necessities. [184]

All of the above theories begin from the same starting block, the block made of state and federal exemptions. Formulating a uniform approach to exemption planning is hindered because of the idea that if a state deems property so necessary to a debtor's existence that the property is exempt from creditor process, then the law should allow the debtor to maximize his or her exemptions, in order to preserve the debtor's right to a fresh start. Professor Steven Harris, in a 1982 article, expounded on this idea and justified pre–bankruptcy exemption planning as both an exercise of the state–created property rights respected in the Code and as a practice consistent with the notion of the fresh start. [185] Professor Harris saw no federal interest in limiting exemption planning, concluding that since Congress allowed the opt–out, Congress endorsed the policies of the various states that encourage the acquisition and preservation of certain assets. [186] The fatal flaw in such reasoning can be found in this question: if the debtor considered the property necessary to his very existence, why did he only find the need to acquire it when the specter of bankruptcy appeared on the horizon? [187] For guidance on this issue, one need look no further than the debate regarding the definition of "reasonably necessary" for the purpose of determining a debtor's disposable income under a chapter 13 plan. [188] In chapter 13, a debtor certainly cannot improve his standard of living, in fact, he is often required to reduce his standard of living. [189]

Most of the courts addressing pre–bankruptcy exemption planning have reached their decisions after applying a fraudulent transfer analysis. [190] This approach is criticized in some of the commentary as causing excessive uncertainty to attorneys advising debtors due to the inconsistencies in application of the fraudulent transfer analysis. [191]

In two articles published shortly after the enactment of the Code, scholars have suggested analogizing pre–bankruptcy asset conversions. Professor Theodore Eisenberg, in a 1981 article addressing several aspects of the Code and proclaiming the Code a "failure," suggested that the Code treat preferential transfers and asset conversions in a similar manner. Part of his reasoning was based on bankruptcy law's inconsistency in disregarding state law in its treatment of asset conversions. [192] Professor Alan Resnick, in a 1978 article,

proposed an amendment to section 522 which would disallow an exemption in property acquired within ninety days of the debtor's bankruptcy filing. [193] However, he proposed disallowance only to the extent that the acquisition exceeded the "reasonable needs of the debtor or his dependents." [194] Such an approach would do little to alleviate the existing uncertainty in the field of exemption planning.

In a recent article, Professors Ponoroff and Knippenberg propose a reconceptualization of pre–bankruptcy exemption planning from a transfer–based concept to a property–based concept. [195] Their criticism of the transfer analogy is based on the fact that exemption planning, while sharing some characteristics of fraudulent transfers and preferential transfers, lacks nearly as many common characteristics. [196] As a result, they propose the concept of "Exemption Property," a state–created property right. [197] Since bankruptcy respects state created interests in property, [198] the result of prohibiting asset conversion would be a taking of a debtor's property interest, with the concomitant grant of that interest to a creditor who did not bargain for that interest, the general unsecured creditor.

The conception of exemption planning as a property right inherent in "Exemption Property" is appealing, but the expansion of the idea of property is one that begs a close examination of the goals of bankruptcy. [199] Certainly the "honest but unfortunate debtor" needs protection, but so do creditors. Professors Ponoroff and Knippenberg criticize estate maximization as the goal of prohibiting asset conversion, [200] but to protect the debtor in exemption planning while ignoring the impact on creditors is to ignore the balance that bankruptcy policy must strike, a balance between debtor interests and creditor interests. [201] While it may be true that the unsecured creditor strikes no bargain at all with respect to the debtor's property, [202] outside bankruptcy, the unsecured creditor is in an all or nothing situation. If the creditor reaches the debtor's unencumbered non–exempt property before the other creditors, the creditor is paid in full; if not, the creditor stands to receive nothing. In bankruptcy, the all or nothing gamble does not exist; the unsecured creditor must wait for its distribution from the estate. The institution of security has been criticized for imposing a fictitious bargain on involuntary creditors and for holding voluntary unsecured creditors to the terms of agreements to which they have no access. [203] The same argument could be made against the concept of Exemption Property; although voluntary unsecured creditors could be presumed to know exemption laws, [204] it is difficult to argue that all unsecured creditors assume the risk that debtors will take full advantage of exemption laws, especially in states where some of the exemptions do not have dollar limits. [205]

It is dangerous to create new property rights that bankruptcy law must respect. There is a growing body of literature regarding the extent of property rights, and the impact of the creation of new property rights on bankruptcy law. [206] If the right to acquire exempt property is a property right inherent in the idea of exemptions, then the right to transfer any property to a creditor can also be considered a property right. [207] Labels do not make a transfer a property right; when a debtor acquires non–exempt assets on the eve of bankruptcy, something has been transferred, either a non–exempt piece of property for cash that is then used to acquire exempt property, or the debtor's non–exempt cash.

If voidable preference law allows the general unsecured creditors to reach the right to transfer property to creditors, [208] asset conversion law must do the same in the absence of a compelling competing interest. That interest, of course, is that of the debtor; a preferential transfer or a fraudulent transfer inures to the benefit of creditors while asset conversion inures to the debtor himself. Whether the asset conversion is conceptualized as a transfer or as a property right, the basic conflict remains. Who is more deserving of the transferred property right, the prepetition creditors who bargained for repayment, or the debtor, for his post–bankruptcy life? [209]

VI. EXEMPTION THEORY

It is said that bankruptcy law, with its attendant discharge, exists to provide relief to the honest but unfortunate debtor. The lack of definition of that honest but unfortunate debtor has not gone unnoticed. [210] In denying debtors' access to chapter 7 and in denying debtors a discharge, courts have fashioned a patchwork conception of the honest but unfortunate debtor. Even the Code itself attempts, at least in the areas of good faith filing [211] and exceptions to discharge, [212] to define who is not an honest but unfortunate debtor. As far as

exemptions go, however, the only attempt under the Code to limit exemption planning is to limit the dollar amount of each itemized exemption. [213] In opt–out states and in states in which the debtor has the choice of either state or federal exemptions, there may be no dollar limit on the items that a debtor may exempt.

It has been said that state and federal exemption laws promote five social policies:

> (1) To provide the debtor with property necessary for his physical survival;
>
> (2) To protect the dignity and the cultural and religious identity of the debtor;
>
> (3) To enable the debtor to rehabilitate himself financially and earn income in the future;
>
> (4) To protect the debtor's family from the adverse consequences of impoverishment;
>
> (5) To shift the burden of providing the debtor and his family with minimal financial support from society to the debtor's creditors. [214]

Consistent with the foregoing policies, exemption laws should be seen as allowing a debtor to shield certain property from creditors; not as entitling debtors to a fixed amount of that property. [215]

The federal policy underlying the fresh start is a major reason that a uniform approach to exemption planning is essential. [216] State exemptions are based on various state policies, including the protection of an individual debtor's welfare. However, state debtor–creditor law does not contemplate a collective proceeding and state laws assume that a debtor will eventually satisfy his or her debts. [217] Although some argue for the abandonment of the idealized honest but unfortunate debtor as a driving bankruptcy concept, it seems that the discharge should be seen as a privilege, not a fundamental right, and that there must be some limits on who is deserving of that discharge. [218] Bankruptcy policy should encourage debtors with non–exempt property to contribute as much property as reasonably possible to satisfy the claims of prepetition creditors. In furtherance of that goal, the standard of an honest but unfortunate debtor should not be abandoned, but rather expanded, and debtors with non–exempt assets available for conversion on the eve of bankruptcy should not be viewed as unfortunate.

Federal exemption policy of course contemplates a collective proceeding. The interests of the creditor play a larger role in bankruptcy law than under state debtor–creditor law. [219] Under bankruptcy law, creditors compete for scarce resources, represented by the estate. [220] Creditors assume certain risks, based on the type of credit they extend. The Code reduces the risks assumed by some unsecured creditors through the scheme of priorities set forth in the Code. [221] Some of the risk assumed by unsecured creditors arises out of each state's exemption laws. It is in the federal interest to regulate this risk somewhat in the interest of regulating the consumer credit system. [222] Therefore, while it is not unreasonable to expect creditors to have some familiarity with state exemption laws, it is consonant with bankruptcy policy to mitigate the risks by imposing a uniform system of allowing and disallowing exemptions.

While the Code balances state and federal policies in allowing exemptions, the concept of the "fresh start" is clearly born of federal bankruptcy policy, [223] since a "fresh start" does not exist under state law. The concept begs a federal definition, one complicated by the range of stinginess to generosity evidenced by the state law exemptions. [224] In the asset conversion cases, some courts attempt to distinguish the fresh start from the running start. In the cases dealing with exemption of retirement accounts under section 522, courts distinguish between the fresh start applicable to the debtor's present existence and the fresh start applicable to the debtor's future. [225] A fresh start encompassing the debtor's future well being stretches beyond the bankruptcy goal of relieving a debtor from prepetition impecuniousness. [226] Allowing debtors to squirrel away property on the eve of bankruptcy inches towards protecting not only the debtor's present ability to provide for himself, but his future ability to provide for himself. [227]

Congress certainly contemplated the safety of the debtor's future in enacting the Code. Employers cannot discriminate against employees solely on the basis of an employee's bankruptcy filing, [228] nor can governmental units discriminate against persons who have filed for bankruptcy protection. [229] Private parties, other than the debtor's employer, may consider a person's bankruptcy in deciding whether or not to do business with that person; as a result, a bank may refuse to extend credit and a landlord may choose not to rent an apartment to a former debtor in bankruptcy. [230] Permissible asset conversion, however, has the effect of forcing creditors to provide for a debtor's future. By allowing a debtor to remove property from the reach of prepetition creditors on the eve of bankruptcy, proponents of permissible conversion effectively force those creditors to subsidize a debtor's future to a greater extent than the creditor would absent the conversion. [231]

Exemptions exist to leave the debtor with real and personal property that the state or federal government deems necessary to the debtor's survival. Permitting a debtor to acquire exempt property on the eve of his or her bankruptcy filing conflicts with the idea that exempt property is necessary property. A case decided under the 1867 Act, *In re Jordan*, [232] found the law regarding bankruptcy exemptions uniform only when laws allow each debtor to exempt that property that is necessary for survival in that debtor's locality. [233] The preference approach to exemption planning takes local interests into account, recognizing as necessary property that the debtor owned for a certain amount of time prior to filing his petition.

VII. THE LAW OF PREFERENTIAL TRANSFERS

Laws prohibiting the transfer of a debtor's property to thwart creditors predate, by many years, the laws prohibiting preferential transfers of a debtor's property. The 1571 Statute of 13 Elizabeth introduced fraudulent transfer law into English law. It was not until 1869 that the Parliament added the concept of a voidable preference into the English law of bankruptcy. [234] Fraudulent transfer law exists both inside and outside bankruptcy, whereas preference law exists only in bankruptcy. Unlike fraudulent transfer law, which is subjective, preference law looks only at the financial condition of the debtor and the effect of a transfer of his property on third party creditors. [235] In 1976, Professors Jackson and Kronman identified the two principal aims of the law of preferences as the protection of the contractual arrangements fashioned by the debtor and his creditors before bankruptcy, and the minimization of the inevitable social costs associated with bankruptcy by spreading its impact among all classes of creditors. [236]

The purpose behind the Code's grant of power to avoid preferential transfers is twofold: to discourage the creditors' race to the courthouse and to further the goal of equality of distribution among creditors. [237] Professor Countryman pointed out in his 1985 article entitled "The Concept of a Voidable Preference in Bankruptcy" that, because of the Code's classification of creditors, there is no bankruptcy policy of equality, but there is a policy of preserving classes and equality within those classes that the preference concept is designed to protect. [238] Under the Code, the debtor occupies a class that is not entitled to payment until all other allowed claims are paid in full. [239] In the law of preferences, it is the effect of the transaction, not the intent of the debtor or the creditor, that is controlling. [240] A debtor's transfer of non–exempt property in order to acquire exempt property on the eve of bankruptcy thwarts the Code's scheme of distribution and should be avoided whether or not the debtor had any fraudulent intent, [241] a state of mind that is difficult to prove. A preferential transfer is not rendered fraudulent because it indirectly hinders or delays creditors.

A Supreme Court case from early in this century lends some weight to the idea that a pre–bankruptcy asset conversion is more correctly viewed as a preferential transfer rather than a fraudulent transfer. [242] In *Van Iderstine v. National Discount Co.*, [243] the Court illustrated some of the differences between fraudulent transfers and preferential transfers under the Act. [244] The court characterized fraudulent transfers as "inherently and always vicious" and "malum per se," and characterized preferential transfers as "innocent and valid, except when made in violation of the express provisions of a statute" and "malum prohibitum—and then only to the extent that it is forbidden." [245] The Court's formulation recognizes that preferential transfers are ones that are valid save but during a specified period, while fraudulent transfers are always wrong. [246] The Court's sentiment was echoed in *Rutter v. General Motors Acceptance Corp.*, [247] which differentiated between preferential and fraudulent transfers by stating that fraudulent transfers involve moral turpitude and prevent discharge while preferential transfers do not. [248] Likewise, the acquisition of exempt property is permissible

and encouraged, but the acquisition of the exempt property should not be permitted, or encouraged, during a specified period before a bankruptcy petition is filed.

VIII. A PROPOSED PREFERENCE PROVISION

Preferential transfers are defined in section 547 of the Code. [249] In order for a trustee to set aside a transfer as preferential, it must be: (1) a transfer; (2) of the debtor's property; (3) to or for the benefit of a creditor; (4) on account of an antecedent debt; (5) made within 90 days before the bankruptcy petition (one year if the transferee is an insider); (6) made while the debtor was insolvent (but there is a 90 day presumption of insolvency); and (7) one that enables the transferee to receive more than it would in a chapter 7 case. [250]

A transfer is "every mode, . . . of disposing of or parting with property or with an interest in property." [251] In order to characterize the conversion of non–exempt property to exempt property as a preferential transfer it is necessary to focus on the second transfer in the usual asset conversion, the acquisition of the exempt property, rather than the first, the sale of non–exempt property, which is the focus of the fraudulent transfer analysis. [252] In cases in which the debtor simply pays down a debt, or uses cash to purchase exempt property, there is only one transfer on which to focus.

Support for this characterization can come from the definition of "transfer" under the UFTA. Under the UFTA, a "transfer" is defined as "every mode, direct or indirect, absolute or conditional, voluntary or involuntary of disposing of or parting with an *asset* or an interest in an asset." [253] An "asset" is "property of a debtor," but the term asset does not include exempt property. [254] If such definitions were to apply to voidable preferences under the Code, then any conversion of non–exempt to exempt property would be a transfer because in all cases, an asset changes hands.

Since the pool of non–exempt property is liquidated to satisfy the claims of creditors [255] and it is the preservation of that pool that is the primary concern to the unsecured creditors, any definition of a preferential transfer should be broad enough to include any transfers of non–exempt property out of the pool of non–exempt property.

Since a preferential transfer is a transfer made to or for the benefit of a creditor, it is necessary to characterize the pool of exempt property as a creditor of the debtor. In order to do that, one should think of the pool of exempt property as the post–bankruptcy debtor. A creditor is defined as an "entity that has a claim against the debtor that arose at the time of or before the order for relief concerning the debtor." [256] An entity includes "person, estate, trust, governmental unit, and United States trustee." [257] Since the definition is inclusive, not exclusive, the pool of exempt property could easily be considered an entity. A claim is any right to payment. [258] During the debtor's pre–bankruptcy life, the pool of exempt property has a claim against the pool of all property of the debtor. This claim matures at the time the bankruptcy case is commenced because at that time, the debtor has the right to exempt certain property. Therefore, the "payment" can be considered the acquisition of exempt property during the debtor's pre–bankruptcy life. No definition of payment appears in the Code, so there is no need to limit payment to the payment of money. The transfer of value into the pool of exempt property can be considered the payment.

The transfer is not to a creditor, but rather for the benefit of a creditor. When the debtor's non–exempt cash is used to acquire an exempt asset, the cash goes into the hands of a third party, but the result of the transfer is that the pool of exempt property is increased, and the post–bankruptcy debtor receives a benefit.

The next element of a preference is also satisfied since the creditor receives more than it would in a chapter 7 case had the transfer not been made and the creditor received payment of the debt to the extent permitted by chapter 7 of the Code. [259] The secured or unsecured status of the creditor is relevant to this "more than" test. A fully secured creditor is not preferred by payments before bankruptcy because a creditor's claim is a secured claim "to the extent of the value of such creditor's interest in the estate's interest in such property." [260] In other words, a fully secured creditor would be paid 100% of its claim in a chapter 7 liquidation, so that no pre–bankruptcy payment would improve its position. Unsecured creditors, on the other hand, are paid

pro–rata according to their priorities under the Code, and no class of unsecured creditors is entitled to payment until the class above it is paid in full. [261] As a result, most payments to unsecured creditors within the preference period result in an improvement in position for the creditor. When a debtor sells non–exempt property in order to acquire exempt property, the estate is also depleted, a result that some courts require as an essential element to the "more than" test. [262]

For purposes of a preference approach to pre–bankruptcy planning, the pool of exempt property should be considered an unsecured rather than a secured creditor. Although the wisdom of allowing a secured creditor to receive more than an unsecured creditor in a bankruptcy distribution is the subject of some debate, [263] secured creditors receive more than unsecured creditors in a bankruptcy distribution because secured creditors have an interest in specific property of the debtor. [264] The interest in the property is not enough for bankruptcy purposes, however, because the property right must be perfected in order for the claim to be a secured one for bankruptcy purposes. [265] Although there are exceptions, [266] in most cases, the act of perfection must be a public act by the creditor, either filing a notice in public records, [267] taking possession of the property, [268] or in the case of motor vehicles, noting the interest on the certificate of title. [269] If a secured creditor's interest is perfected within the preference period, that perfection results in a preference, if all the other requirements of section 547 are met, even though the transfer, the granting of the security interest, had been made previously. [270]

A debtor can generally give a creditor a security interest in exempt property, and except in cases covered by section 522(f) of the Code, that security interest is valid in bankruptcy. The security interest has priority over the debtor's right to the exemption, since the exemption attaches only to the debtor's equity in the property. [271] If one were to consider a debtor's right to exempt certain property a perfected right, such a grant of a security interest would be subordinate to the debtor's right to the exemption.

It is helpful to think of a state's exemption statute as giving the pool of exempt property an unperfected claim against the debtor. In theory, a creditor could look at the debtor's assets and see what non–exempt and exempt property the debtor owns. The debtor's ownership of the exempt property can be deemed a perfected transfer. However, the right granted by the statute to exempt certain property is best seen as an unperfected right, since there is the possibility that the debtor might never need some of the property listed as exempt. This position is supported by the Uniform Commercial Code, under which a secured party's interest in collateral cannot attach until the debtor has rights in the collateral. [272] This argument is admittedly most compelling in the case of unlimited exemptions, since viewing such a statute as giving a debtor a perfected right to exempt property could lead to "no–asset" cases in most bankruptcy cases. [273]

Even if one were to classify a state's exemption statute as the kind of public notice necessary for perfection of a security interest, it would be the debtor's acquisition of the property that would be the act necessary for perfection. Just as floating liens on inventory can be avoided as preferential transfers, [274] so should acquisitions of exempt property during the preference period. The actual acquisition need not be avoided, just the "lien," or exemption claim.

A transfer is only preferential if it is made for or on account of an antecedent debt. Here is where the idea of a debtor's right to his state's exemptions is useful. If one views the statute governing exemptions as one that gives the pool of exempt property a claim against all other assets of the debtor, then such a claim remains unsatisfied until the debtor acquires property that can be classified as exempt. The Code defines "debt" as "liability on a claim." [275] As a result, any transfer of the debtor's property into the pool of exempt property is a transfer on account of an antecedent debt.

In order to apply preference laws to pre–bankruptcy exemption planning, the transfer must be made while the debtor is insolvent. Under the Code, there is a presumption that the debtor is insolvent during the 90 days prior to the date of filing the petition in bankruptcy. The 90 day presumption of insolvency is rebuttable. [276]

The Code defines "insolvent" in the case of an individual, as the financial condition in which the sum of the person's debts is greater than all of the person's property, exclusive of fraudulently transferred property and

exempt property. [277] The definition of insolvency should be expanded for the purposes of a preference section addressing pre–bankruptcy planning. Under the UFTA, a debtor who is not generally paying his or her debts as they become due is presumed insolvent. [278] A pre–bankruptcy planning preference provision should add the UFTA insolvency test to the Code's insolvency test and provide that the debtor is insolvent if the debtor's financial condition satisfies either test. The "generally not paying" test is already in the Code in the section dealing with involuntary petitions. [279] If the preference avoidance power is designed to avoid transfers made in contemplation of bankruptcy, then the expanded definition of insolvency would better further the desired goal, since an individual who is generally not paying debts is likely contemplating bankruptcy. A debtor who is solvent based on the Code's balance sheet test should not be permitted to render himself insolvent shortly before his bankruptcy filing.

The last element to be satisfied deals with the timing of the transfer. A transfer that meets all of the other elements of a preference is avoidable if made within 90 days before the petition is filed unless the creditor is an insider, in which case, the transfer is avoidable if made within one year of the filing. [280] When the transfer results in the acquisition of exempt property, the time frame should be that applicable to the insider transferee. Again, the definition of "insider" is inclusive, not exclusive, [281] and includes a relative of the debtor, a partnership in which the debtor is a partner, a general partner of the debtor and a corporation of which the debtor is a director, officer or person in control. [282] Since the post–bankruptcy debtor is a later incarnation of the debtor himself, the creditor fits nicely in to the definition of "insider" of the pool of non–exempt property. [283]

Pursuant to the Code's preference avoidance power, the trustee may recover the transferred property from the transferee or the entity for whose benefit the transfer was made. [284] For purposes of exemption planning, the trustee should be able to avoid the exemption — that is, get the property back from the creditor for whose benefit the transfer was made, not from the actual transferee. Thus, the property would be restored to the pre–bankruptcy debtor, or the pool of non–exempt property.

The existing preference avoidance provisions in section 547 of the Code contain some exceptions; that is, certain transfers that would otherwise be preferences are not avoidable. [285] A preference provision dealing with pre–bankruptcy asset conversions should likewise contain exceptions; there are certain acquisitions of exempt property that the Code need not prohibit.

Some of the existing commentary addressing pre–bankruptcy asset conversions extols the debtor's right to keep "necessities," exemption laws providing the definition of what is necessary. [286] A workable preference provision should contain a much narrower definition of necessity. The Code contains, as do several state exemption statutes, an exemption for professionally prescribed health aids. [287] Any conception of the fresh start assumes a debtor is alive and perhaps well to enjoy it. The purchase of a wheelchair is unlikely to raise eyebrows; even if some creditors object, woe to the creditor who actually attempts to set aside such a purchase as preferential.

Another exception to the preference avoidance power is for transfers that constitute transfers for "substantially contemporaneous" value given by the creditor to the debtor. [288] Likewise, transfers of exempt property for exempt property would also be excepted from the proposed section, since these transfers result in no overall loss to the estate.

In the business bankruptcy context, payments made on debts in the ordinary course of the debtor's business are not avoidable. [289] In the consumer context, it is possible to view home mortgage payments in the same light. Making regular payments on a home mortgage loan, while perhaps increasing the debtor's equity in an exempt asset, is again not the kind of asset transfer on which Congress should frown. A similar argument can be made for regular payments into a retirement plan. Support for such an exemption from preference treatment comes from the legislative history of the Code. Courts often cite that history for the proposition that "the conversion of non–exempt assets into exempt assets on the eve of bankruptcy is not, standing alone, fraudulent." [290] However, those considering the Code before its enactment were not unanimously supportive of bankruptcy planning, and the same letter from which the last quote is taken also distinguishes the ordinary

life maintenance payments of the debtor from "the deliberate enlargement of exemptions out of the usual and customary manner of living and in contemplation of bankruptcy." [291] The author, then Bankruptcy Judge Phelps, considered the former to be within the realm of permissible pre–bankruptcy activity and the latter to be a form of cheating which "shocks one's conscience" and "bring[s] the whole bankruptcy process into disrepute." [292]

IX. CONCLUSION

The preference analogy, like those that have come before, is imperfect. Any restriction on exemption planning raises a cry that such a restriction favors the more sophisticated debtors over the those who are less sophisticated. There is nothing in the proposed preference provision that would prevent a debtor from filing a bankruptcy petition one year and a day after converting a substantial amount of property from non–exempt to exempt status. Certainly the fraudulent transfer analogy remains available when the debtor's conduct is so egregious as to raise a question of his eligibility for a discharge. [293] However, the cases show that in many asset conversions the debtor is converting a wealth producing, liquid asset, such as cash, into an illiquid asset, such as a home or a retirement account. If the debtor can live without the liquid asset for a year and a day, the transfer should remain untouched. However, if the debtor needs to file bankruptcy as a result of the transfer, it is conceivable that the transfer should not have taken place at all.

A preference approach to pre–bankruptcy planning would further the desirable goal of uniformity in the bankruptcy laws and would provide some certainty to courts and to debtors' attorneys. Such an approach would also balance two interests that sometimes appear at odds with each other: the state interest in allowing its residents the exemptions chosen by the state and the federal interest in a uniform policy governing an individual's bankruptcy discharge.

FOOTNOTES:

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[1] *See* 5 Collier on Bankruptcy ¶ 547.01, at 547 (Lawrence P. King et al. eds., 15th ed. rev. 1997)
(a debtor is permitted to prefer one or more creditors when transfer or payment pays or secures legitimate debt and violates no statute); Thomas H. Jackson, The Logic and Limits of Bankruptcy Law 124 (1986).Back To Text

[2] 11 U.S.C. §§ 101 et seq. (1994).Back To Text

[3] State fraudulent conveyance laws are generally based on one of three statutes, the English Statute of Elizabeth, 13 Eliz. c.5 (1571), the Unif. Fraudulent Conveyance Act (1985) and the Unif. Fraudulent Transfer Act (1985).

The Code allows a trustee to avoid a transfer of the debtor's property if the transfer was made on or within one year before the date of filing the bankruptcy petition if the debtor transferred the property with actual intent to hinder, delay or defraud any creditor, or if the debtor received less than a reasonably equivalent value for the property and the debtor was either insolvent at the time of transfer or became insolvent as a result of the transfer, the debtor was engaged in a business or transaction for which any property remaining was insufficient, or the debtor intended to incur, or believed that he would incur, debts beyond the debtor's ability to pay. *See* 11 U.S.C. § 548.

The Code also allows a trustee to avoid a transfer of a debtor's property if that transfer would be voidable under state fraudulent transfer law if there is an actual creditor of the debtor who can avoid the transfer. *See*

11 U.S.C. § 544(b).Back To Text

[4] *See id.* § 547.Back To Text

[5] *See id.* § 522(d) (exempting certain property of individual debtors).Back To Text

[6] The Senate version of the bill followed the scheme of the Bankruptcy Act of 1898 (the "Act") and incorporated state and non–bankruptcy federal exemptions. *See* Sen. Rep. No. 95–989 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5861. The House version provided for federal bankruptcy exemptions and allowed the debtor a choice between those exemptions and the exemptions provided under the debtor's state law. *See* H.R. No. 95–595 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5787, 6087 (1977).Back To Text

[7] An individual has a choice between exempting the property listed in section 522(d) or exempting property according to federal non–bankruptcy law and state law, unless the state law mandates that a debtor use state exemptions. *See* 11 U.S.C. § 522(b). Back To Text

[8] *See* Nat'l Bankr. Rev. Comm'n, Bankruptcy: The Next Twenty Years, Final Report 299–301 (1997) [hereinafter Commission Report] (listing states that do not permit resident debtors to use the section 522(d) exemptions).Back To Text

[9] *See* Alan N. Resnick, *Prudent Planning or Fraudulent Transfer? The Use of Nonexempt Assets to Purchase or Improve Exempt Property on the Eve of Bankruptcy*, 31 Rutgers L. Rev. 615, 622–26 (1978) (providing examples from several states, including: Connecticut's exclusion of beds, New York's exemption for bibles and New York, Maine, Mississippi, and Ohio's exemption for tools of trade and machinery).Back To Text

[10] *See* discussion *infra* Part III (discussing recent pre–bankruptcy planning cases).Back To Text

[11] *See* Jackson, *supra* note 1, at 276.Back To Text

[12] *See* Bank of Pa. v. Adlman (*In re* Adlman), 541 F.2d 999, 1003 (2d Cir. 1976) (noting transfer of non–exempt assets does not compel conclusion of fraudulent transfer); Crews v. First Colony Life Ins. Co. (*In re* Barker) 168 B.R. 773, 776 (Bankr. M. D. Fla. 1994) (asserting "section 522 of the Bankruptcy Code provides little guidance since it fails either to mention conversion or the result of a pre–bankruptcy conversion.").Back To Text

[13] *See* 11 U.S.C. § 727(a)(2) (1994) (providing basis for denial of a discharge); *id.* § 522 (providing basis for denial of an exemption).Back To Text

[14] *See id.* § 727(a) (providing when discharge shall be granted).Back To Text

[15] The same argument, of course, holds true for those who propose a uniform exemption law. *See infra* Part III and accompanying text.Back To Text

[16] In most cases, debtors convert their non–exempt property to exempt property on advice of their lawyer. *See, e.g.*, *In re* Moore, 177 B.R. 437, 439 (Bankr. N.D.N.Y. 1994) (noting actions of debtor largely taken at recommendation of his attorney); Albuquerque Nat'l Bank v. Zouhar (*In re* Zouhar) 10 B.R. 154, 158 (Bankr. D.N.M. 1981) (same). However, there do not yet appear to be any cases in which an attorney was sanctioned for giving such advice to a client. *See* Jay A. Cristol, et al., *Exemption Planning: How Far May You Go*, 48 S.C. L. Rev. 715, 730–731 (1997) ("[C]ounsel is handicapped by the vague line between appropriately sheltering the debtor's assets and engaging in conduct that might later result in the loss of the debtor's discharge (and disciplinary or criminal actions against the attorney).").Back To Text

[17] *See, e.g.,* Williams v. United States Fidelity & Guar. Co., 236 U.S. 549, 554–55 (1915) (stating purpose of Bankruptcy Act is for debtor to "start afresh"). Back To Text

[18] Some creditors are "more equal than others." *See* George Orwell, Animal Farm 118 (1946). The Code sets forth priorities among unsecured creditors in 11 U.S.C. § 507. *See also* 1 Collier, *supra* note 1, ¶ 1.03 [2][a], at 1–21(asserting that purpose of chapter 7 is to distribute debtor's assets equitably).Back To Text

[19] *See In re* Neiheisel, 32 B.R. 146, 161–62 (Bankr. D. Utah 1983) (discussing Code reforms favorable to a fresh start for debtors and the debate between the House and Senate on exemptions); *In re* Vasko, 6 B.R. 317, 321 (Bankr. N.D. Ohio 1980) (noting one area of congressional concern regarding debtor's fresh start was exemption system).Back To Text

[20] *See* Redmond v. Ellis County Abstract & Title Co. (*In re* Liberty Livestock), 198 B.R. 365, 375 (Bankr. D. Kan. 1996) (stating loans between insiders deserve scrutiny to insure policy of equal treatment of creditors).Back To Text

[21] *See* 11 U.S.C. § 362 (1994). The stay stops collection actions against the debtor, subject to exceptions contained in section 362(b), during the pendency of the bankruptcy case.Back To Text

[22] *See id.* § 507 (prioritizing claims against bankruptcy estate); *id.* § 506 (defining secured claims).Back To Text

[23] The power to avoid preferential transfers allows a trustee to avoid certain transfers of the debtor's property "to or for the benefit of a creditor." *Id.* § 547(b)(1).Back To Text

[24] The Code's fraudulent transfer provision allows the trustee to avoid certain "transfers." *Id.* § 548. The Code defines "transfer" as "every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property." 11 U.S.C. § 101(54).Back To Text

[25] *See* Lowell P. Bottrell, *Comfortable Beds, A Church Pew, A Cemetery Lot, One Hog, One Pig, Six Sheep, One Cow, A Yolk of Oxen or a Horse, And Your Notary Seal: Some Thoughts About Exemptions*, 72 N.D. L. Rev. 83, 92 (1996) (stating that debtor converts non–exempt property to exempt to avoid creditors). Back To Text

[26] *See* 11 U.S.C. § 727(a)(2) (allowing creditors to move for denial of debtor discharge); *id.* § 522(c) (allowing creditors to move for denial of debtor exemptions); *id.* § 548 (allowing trustee to move for avoidance of fraudulent transfers). Back To Text

[27] *See* 11 U.S.C. § 727(a)(2) (stating when debtor shall be discharged). *See, e.g.,* Swift v. Bank of San Antonio (*In re* Swift), 3 F.3d 929, 930 (5th Cir. 1993) (denying discharge to debtor who attempted to delay or defraud creditors); Norwest Bank Neb. v. Tveten (*In re* Tveten), 848 F.2d 871, 874 (8th Cir. 1988) (finding "proscription against discharging debtor with fraudulent intent in a Chapter 7 proceeding is equally applicable against debtor applying for Chapter 11"); First Texas Sav. Ass'n v. Reed (*In re* Reed), 700 F.2d 986, 988 (5th Cir. 1983) (denying discharge under section 727 of the Code).Back To Text

[28] 11 U.S.C. § 522. *See, e.g.,* Hanson v. First Nat'l Bank in Brookings, 848 F.2d 866, 868 (8th Cir. 1988) (allowing debtors to claim exemptions for property obtained on eve of bankruptcy); *In re* Schwarb, 150 B.R. 470, 472 (Bankr. M.D. Fla. 1992). There is nothing in the language of section 522 that addresses the conversion of non–exempt property to exempt property. As a result, courts look to whether the debtor acted with the specific intent to defraud his creditors.Back To Text

[29] *See, e.g.,* Mueller v. Redmond (*In re* Mueller), 867 F.2d 568, 569 (10th Cir. 1989). Pursuant to the Kansas statute under which the debtor claimed his exemption in a life insurance policy, the value of such a policy was not exempt from the claims of creditors if the debtor filed a bankruptcy petition within one year after the date the policy was issued if the policy was "obtained by the debtor for the purpose of defrauding one or more of the debtor's creditors." *Id.* For a discussion of various state exemption statutes that disallow fraudulently obtained exemptions, see William Houston Brown, *Political and Ethical Considerations of Exemption*

Limitations: The "Opt−Out" as Child of the First and Parent of the Second, 71 Am. Bankr. L.J. 149, 183−186 (1997).Back To Text

[30] *See, e.g.*, Crews v. First Colony Life Ins. Co. (*In re* Barker), 168 B.R. 773, 780 (Bankr. M.D. Fla. 1994); Staats v. Beckman (*In re* Beckman), 104 B.R. 866, 874 (Bankr. S.D. Ohio 1989).Back To Text

[31] *Barker*, 168 B.R. at 776. The court, after notice and a hearing, may dismiss a case for cause, and the court, on its own motion or that of the United States Trustee may dismiss a case filed by an individual debtor with primarily consumer debts if the granting of relief would be a "substantial abuse" of chapter 7. *See* 11 U.S.C. § 707(b) (1994); *see also* Brown, *supra* note 29, at 198−99. Back To Text

[32] *See* Norwest Bank Neb. v. Tveten (*In re* Tveten), 848 F.2d 871, 873 (8th Cir. 1988) (noting scope of exemption determined by state law); Hanson v. First Nat'l Bank in Brookings, 848 F.2d 866, 868 (8th Cir. 1988) (same); Carletta v. Up State Federal Credit Union (*In re* Carletta), 189 B.R. 258, 262−63 (Bankr. N.D.N.Y. 1995) (allowing conversion of non−exempt property to be converted to exempt under state law on eve of bankruptcy).Back To Text

[33] The Commission was established by Congress pursuant to the Bankruptcy Reform Act of 1994. The Commission issued its final report on October 20, 1997 and terminated by law on November 19, 1997. *See* Commission Report, *supra* note 8, at viii.Back To Text

[34] *See supra* notes 5−9 and accompanying text.Back To Text

[35] *See* Commission Report, *supra* note 8, at 125.Back To Text

[36] *See* Resnick, *supra* note 9, at 621 (discussing that over years, states' motivations in enacting exemption laws have changed). Early in this country's history, some western and southern states enacted generous exemption laws to encourage settlers. *See* William J. Woodward, Jr., *Exemptions, Opting Out and Bankruptcy Reform*, 43 Ohio St. L.J. 335, 337 (1982) (explaining states also wanted to keep people productive and protect families).

Prior to the Code's enactment in 1978, there was a perception that there was general uniformity under the Act, which contained no federal exemptions. Some argued that any differences in state and federal exemptions in bankruptcy would give someone an incentive to file for bankruptcy: debtors, if the federal exemptions were more generous than those under state law, creditors, filing involuntary petitions if the converse were true. *See* William J. Woodward, Jr., *Exemptions Opting Out and Bankruptcy Reform*, 43 Ohio St. L.J. 335, 342 (1982).Back To Text

[37] *See, e.g.*, Ariz. Rev. Stat. § 33−1126 (C) (Supp. 1997); Colo. Rev. Stat. § 13−54−102(1)(s) (Supp. 1997); Idaho Code § 11−604A (1997); 42 Pa. Cons. Stat. § 8124(b)(1)(ix) (Supp. 1997).Back To Text

[38] *See* Idaho Code § 11−604A(1) (providing "[i]t is the policy of the state of Idaho to ensure the well−being of its citizens by protecting retirement income to which they are or may become entitled").Back To Text

[39] *See* 42 Pa. Cons. Stat. § 8124(b)(1)(ix).Back To Text

[40] *See* Ariz. Rev. Stat. § 33−1126(C).Back To Text

[41] *See* N.Y. Debt. & Cred. Law § 283(1) (McKinney's 1990). Back To Text

[42] For a discussion of the proper role of the lawyer in advising clients prior to a bankruptcy filing, see Cristol, *supra* note 16, at 728−731.Back To Text

[43] *See* 11 U.S.C. § 727(a)(2) (1994) (stating debtor will not be discharged if transfers with intent "to hinder, delay or defraud a creditor").Back To Text

[44] There appear to be two approaches to this: under the first, the exemption is denied under 11 U.S.C. § 522; under the second, the sale of non–exempt property is avoided as a fraudulent transfer under 11 U.S.C. § 548. *See supra* notes 23–26 and accompanying text. The trustee or any creditor may file objections to the debtor's list of exempt property under Bankruptcy Rule 4003(b). *See* Fed. R. Bankr. P. 4003(b). Back To Text

[45] *See* 11 U.S.C. § 524 (setting forth effects of discharge).Back To Text

[46] *See id.* Back To Text

[47] *See* Norwest Bank Neb. v. Tveten (*In re* Tveten), 848 F.2d 871, 873–74 (8th Cir. 1988) (allowing Minnesota state exemption for life insurance with fraternal benefit association); *see also* First Texas Sav. Ass'n v. Reed (*In re* Reed), 700 F.2d 986, 991 (5th Cir. 1983) (noting separate standards for claiming of exemption and denying discharge). Back To Text

[48] *See Tveten*, 848 F.2d at 872–73 (discussing conversion of investment real estate to exempt life insurance as non–fraudulent); *see also* Panuska v. Johnson (*In re* Johnson), 880 F.2d 78, 84 (8th Cir. 1989) (finding transfer of property for homestead exemption non–fraudulent); Ford v. Poston (*In re* Ford), 773 F.2d 52, 54 (4th Cir. 1985) (examining whether transfer of real estate to spouse for Virginia exemption was fraudulent).Back To Text

[49] *See Tveten*, 848 F.2d at 872; *see also* Hanson v. First Nat'l Bank, 848 F.2d 866, 867–69 (8th Cir. 1988) (discussing sale of motor vehicles to son and purchasing homestead with proceeds).Back To Text

[50] The court in *In re Barker*, while finding an intent to defraud creditors on the part of the debtor, noted that an intent to hinder or delay creditors would be sufficient to deny the exemption under section 548. *See* Crews v. First Colony Life Ins. Co. (*In re* Barker), 168 B.R. 773, 778–79 (Bankr. M.D. Fla. 1994). *See infra* notes 71–78 and accompanying text.Back To Text

[51] 11 U.S.C. § 727(a)(2) (1994).Back To Text

[52] *Id.* § 548(a)(1).Back To Text

[53] In order for a transfer to be set aside as fraudulent based on constructive fraud, the debtor must have received less than a "reasonably equivalent value" for the transfer. *See id.* § 548. In most of the exemption planning cases, the debtor has received an equivalent value for the property transferred.Back To Text

[54] Under section 522(*l*), the debtor must file a list of property, which the debtor claims as exempt. Such property will be exempt "unless a party in interest objects." *Id.* § 522(*l*).Back To Text

[55] *See* Hanson v. First Nat'l Bank, 848 F.2d 866, 868 (5th Cir. 1988). Sometimes, state laws deny an exemption to a debtor who has fraudulently acquired an exempt asset. *See also* Mueller v. Redmond (*In re* Mueller), 867 F.2d 568, 569 (10th Cir. 1989) (stating Kansas law exempts nonforfeiture value of life insurance unless debtor acquires policy within one year before filing for bankruptcy and policy was obtained by debtor for purpose of defrauding creditors); Staats v. Beckman (*In re* Beckman), 104 B.R. 866, 873 (Bankr. S.D. Ohio 1989) (stating Ohio exemption law allowed debtor to exempt annuities in unlimited amount except to extent that premiums were paid "in fraud of creditors").

Some courts do not deny exemptions under the Code, relying on the plain language (or lack of same) of the Code. *See Barker*, 168 B.R. at 776.Back To Text

[56] Norwest Bank Neb. v. Tveten (*In re* Tveten), 848 F.2d 871, 874; *Hanson*, 848 F.2d at 868; Carletta v. Up State Fed. Credit Union (*In re* Carletta), 189 B.R. 258, 261 (N.D.N.Y. 1995) (granting debtor's cross–motion for summary judgment). *But see In re* Schwarb, 150 B.R. 470, 473 (Bankr. M.D. Fla. 1992) (finding conversion of non–exempt asset into exempt asset for specific purpose of placing asset out of reach of

creditors is sufficient to deprive debtor exemption).Back To Text

[57] First Texas Sav. Ass'n v. Reed (*In re* Reed), 700 F.2d 986 (5th Cir. 1983).Back To Text

[58] *Id.* at 991.Back To Text

[59] *See id.* at 988–89.Back To Text

[60] *See id.* at 989.Back To Text

[61] *See id.Back To Text*

[62] *See Reed*, 700 F.2d at 991–92.Back To Text

[63] *See* Panuska v. Johnson (*In re* Johnson), 880 F.2d 78, 80–82 (8th Cir. 1989) (protesting debtor's discharge under section 727(a)(2) because debtor satisfied two homestead mortgages, a marriage dissolution lien and purchased annuities, individual retirement accounts, life insurance and musical instruments before filing a chapter 7 petition); Hanson v. First Nat'l Bank, 848 F.2d 866, 869–70 (8th Cir. 1988) (objecting under section 522 to debtor's purchase of exempt life insurance policies and prepayment of mortgage on homestead); Staats v. Beckman (*In re* Beckman), 104 B.R. 866, 870–871 (Bankr. S.D. Ohio 1989) (discussing trustee's objection under section 548 and Ohio's exemption statute to debtor's purchase of exempt life insurance policies several days before filing chapter 7 petition). Back To Text

[64] *See Hanson*, 848 F.2d at 868 (noting absent extrinsic evidence, debtor's conversion of non–exempt property to exempt, while insolvent, will not be deemed fraudulent).Back To Text

[65] Unif. Fraudulent Transfer Act § 4(b) (1985).Back To Text

[66] *See id.* (listing badges of fraud).Back To Text

[67] *See id.* § 4(b)(4). Back To Text

[68] The estate is created when the bankruptcy case is commenced and the estate consists of "all legal or equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C. § 541 (1994).Back To Text

[69] *See In re* Schwarb, 150 B.R. 470, 472 (Bankr. M.D. Fla. 1992).Back To Text

[70] *See id.* at 473.Back To Text

[71] *See* Lawrence Ponoroff & F. Stephen Knippenberg, *Debtors Who Convert their Assets on the Eve of Bankruptcy: Villains or Victims of the Fresh Start?*, 70 N.Y.U. L. Rev. 235, 243–83 (1995) (discussing debtors who convert all or most of their assets to avoid creditors' claims).Back To Text

[72] Unif. Fraudulent Transfer Act § 1(2) (1985). Back To Text

[73] *See generally* Ponoroff & Knippenberg, *supra* note 71, at 235.Back To Text

[74] *See supra* notes 48–56 and accompanying text.Back To Text

[75] For cases noting the resulting insolvency of the debtor as an important factor in denying either the exemption or the discharge, see, for example, Mueller v. Redmond (*In re* Mueller), 867 F.2d 568, 569–70 (10th Cir. 1989); Staats v. Beckman (*In re* Beckman), 104 B.R. 866, 868–69 (Bankr. S.D. Ohio 1989); Albuquerque Nat'l Bank v. Zouhar (*In re* Zouhar), 10 B.R. 154, 158 (Bankr. D.N.M. 1981) (decided under

Act). *But see* Up State Fed. Credit Union v. Carletta (*In re* Carletta), 189 B.R. 258, 263 (Bankr. N.D.N.Y. 1995) (upholding debtors' claim of exemption in spite of fact that debtors used last $7,500 to purchase exempt life insurance policies).Back To Text

[76] 10 B.R. 154 (Bankr. D.N.M. 1981).Back To Text

[77] *See id.* at 157 (stating since amount transferred would have been sufficient to pay creditor, it must be labeled fraudulent).Back To Text

[78] *See id.*Back To Text

[79] Swift v. Bank of San Antonio, 3 F.3d 929, 931 (5th Cir. 1993).Back To Text

[80] 848 F.2d 866 (8th Cir. 1988).Back To Text

[81] 848 F.2d 871 (8th Cir. 1988).Back To Text

[82] *See Hanson*, 848 F.2d at 867 (discussing limits of South Dakota law with respect to exemptions).Back To Text

[83] *See Tveten*, 848 F.2d at 872.Back To Text

[84] *See id.* While Dr. Tveten's bankruptcy case was pending, the Supreme Court of Minnesota held that Minnesota's exemption provisions violated the Minnesota Constitution. *See In re* Tveten, 402 N.W.2d 551 (Minn. 1987) (finding unlimited exemption provision was unconstitutional because Minnesota Constitution provided "reasonable amount of property" shall be exempt from creditors' claims and because annuities issued by fraternal benefit society were exempt without limit while there were limits on debtor's ability to exempt annuities issued by for–profit insurance company).Back To Text

[85] *See Hanson*, 848 F.2d at 870 (Arnold, J., concurring) (maintaining that it is well established that debtor's conversion of non–exempt property to exempt is not sufficient to deprive debtor of exemptions he would be entitled to); *see also Tveten*, 848 F.2d at 873–74 (stating conversion of property to exempt from non–exempt to place assets out of reach of creditors is not sufficient to deprive debtor of entitled exemptions).Back To Text

[86] *See Hanson*, 848 F.2d at 867 (stating that debtors sold car, two vans and motor home for $27,115 and household items for $7,300, appraisal value of property); *Tveten*, 848 F.2d at 872–73 (noting debtor sold almost all non–exempt property, and there were no claims made that they were sold at less than fair market value).Back To Text

[87] *See Hanson*, 848 F.2d at 867–68 (finding sale of assets was made properly); *Tveten*, 848 F.2d at 872–73 (same).Back To Text

[88] *See Hanson*, 848 F.2d at 868–69 (noting no other extrinsic evidence was found to warrant fraudulent claim); *Tveten*, 848 F.2d at 874–75 (stating that lower court's finding of extrinsic evidence was not clearly erroneous and therefore affirmed).Back To Text

[89] *See Hanson*, 848 F.2d at 870 (Arnold, J., concurring) (noting amount of property converted in *Hanson* was much less than that of *Tveten*).Back To Text

[90] *See Hanson*, 848 F.2d at 867 (stating dollar limit for exemption in South Dakota is $20,000, taken from S.D. Codified Laws Ann. §§ 43–45 (1983)); *Tveten*, 848 F.2d at 873 (noting Minnesota exemption has no monetary limit).Back To Text

[91] *See Tveten,* 848 F.2d at 875–76 (discussing need for limit of exemption in order to uphold meaning and purpose of Code).Back To Text

[92] *See id*. Exemption statutes should further one or more of five policies:

> (1)To provide the debtor with property necessary for his physical survival; (2) To protect the dignity and the cultural and religious identity of the debtor; (3) To enable the debtor to rehabilitate himself financially and earn income in the future; (4) To protect the debtor's family from the adverse consequences of impoverishment; (5) To shift the burden of providing the debtor and his family with minimal financial support from society to the debtor's creditors.

Resnick, *supra* note 9, at 621.Back To Text

[93] *See Tveten*, 848 F.2d at 876 (discussing limits needed to preserve meaning of Code and prevent fraud).Back To Text

[94] *See* Albuquerque Nat'l Bank v. Zouhar (*In re* Zouhar), 10 B.R. 154, 155–56 (Bankr. D.N.M. 1981) (noting debtor attempted to shield approximately $47,000).Back To Text

[95] *See id.* (discussing facts and circumstances leading to claim).Back To Text

[96] *See id.* at 157 (stating that under New Mexico's statute unlimited exemptions are permitted).Back To Text

[97] *See id.* at 155 (discussing debtor's purchase of house and payment of son's tuition as part of planning for proceedings).Back To Text

[98] A debtor's ability to avoid debts arising from a divorce has been limited under the Code. Claims for alimony, maintenance or support are not dischargeable, 11 U.S.C. § 523(a)(5)(1994), and other debts incurred in the course of a divorce or separation are not dischargeable if the debtor does not have the ability to pay such debt or discharging such debt would result in a benefit to the debtor that outweighs the detriment to the debtor's spouse, former spouse or child. *See id.* § 523(a)(15).Back To Text

[99] *See Zouhar*, 10 B.R. at 155–56 (outlining debtor's assets, income, and financial obligations).Back To Text

[100] *See* Bankruptcy Act of 1898 § 14(c)(4).Back To Text

[101] *See Zouhar*, 10 B.R. at 158 (holding objection to discharge sustained and discharge denied).Back To Text

[102] *See id.* at 157 (using "pig to hog" analysis, which recognizes some pre–bankruptcy planning is appropriate, but wholesale conversion of non–exempt assets into exempt assets is not).Back To Text

[103] *See id.* at 156 (finding possibility of debtor emerging from bankruptcy with net worth of $130,000 was abuse of bankruptcy process).Back To Text

[104] *Id*.Back To Text

[105] *Id.* at 157.Back To Text

[106] *See Zouhar*, 10 B.R. at 154 (debtor testifying he had pre–paid son's tuition with assets that would otherwise go to trustee).Back To Text

[107] Swift v. Bank of San Antonio (*In re* Swift), 3 F.3d 929, 931 (5th Cir. 1993) (stating "bankruptcy court has the primary duty to distinguish hogs from pigs"); *Zouhar*, 10 B.R. at 154 (stating "[t]here is a principle of too

much; phrased colloquially, when a pig becomes a hog it is slaughtered") (quoting Dolese v. United States, 605 F.2d 1146, 1154 (10th Cir. 1979)).Back To Text

[108] *See*, *e.g.*, J. Thomas Oldham, *Key to a Cozier Bankruptcy: Location, Location, Location*, N.Y. Times, Jan. 7, 1998, at A1 ("Florida and Texas — and to a lesser degree, Iowa, Kansas and South Dakota — have fast become debtors' paradises, allowing big spenders who file for bankruptcy to keep not just luxurious homes but often millions of dollars in wages, annuities and pension income as well.").Back To Text

[109] 168 B.R. 773 (Bankr. M.D. Fla. 1994).Back To Text

[110] *See* Fla. Stat. § 222.14 (1992).Back To Text

[111] *See Barker*, 168 B.R. at 775.Back To Text

[112] *See id.Back To Text*

[113] *See id.*Back To Text

[114] 880 F.2d 78 (8th Cir. 1989).Back To Text

[115] The annuities and retirement accounts were not in dispute as a result of the state court decision regarding the constitutionality of Minnesota's exemptions. *See supra* notes 81–84 and accompanying text.Back To Text

[116] *See Johnson*, 880 F.2d at 79.Back To Text

[117] *See id.* at 81.Back To Text

[118] *See id.* at 82.Back To Text

[119] *See id.* at 83.Back To Text

[120] *Id.* at 82.Back To Text

[121] *Johnson*, 880 F.2d at 81.Back To Text

[122] 932 F.2d 1100 (5th Cir. 1991).Back To Text

[123] *See id.* at 1102.Back To Text

[124] *See id.* at 1103.Back To Text

[125] *See* Commission Report, *supra* note 8, at 299–301.Back To Text

[126] *See*, *e.g.*, Miller v. Levine (*In re* Levine), 166 B.R. 967, 968 (Bankr. M.D. Fla. 1994) (debtors moved from Colorado to Florida); *In re* Coplan, 156 B.R. 88, 89 (Bankr. M.D. Fla. 1993) (debtors moved from Wisconsin to Florida).Back To Text

[127] For a case holding that the desire to shield assets from creditors is enough, see *In re Schwarb*, 150 B.R. 470, 473 (Bankr. M.D. Fla. 1992). *See also* Ford v. Poston (*In re* Ford), 53 B.R. 444, 450 (W.D. Va. 1984) (upholding denial of discharge because primary motivation for conversion was debtor's intention to shield assets from creditors).Back To Text

[128] 156 B.R. 88 (Bankr. M.D. Fla. 1993).Back To Text

[129] *See id.* at 90–91 (noting Wisconsin had $40,000 homestead exemption and Florida had unlimited homestead exemption).Back To Text

[130] *See* 11 U.S.C. § 522 (1994).Back To Text

[131] *Id.* § 548 (providing one year statute of limitations for actions to set aside fraudulent transfers).Back To Text

[132] *Coplan*, 156 B.R. at 92.Back To Text

[133] Crews v. First Colony Life Ins. Co. (*In re* Barker), 168 B.R. 773, 775 (Bankr. M.D. Fla. 1994).Back To Text

[134] *See id.* at 776.Back To Text

[135] *See id*. at 777.Back To Text

[136] *See id.Back To Text*

[137] *See id.* The Bankruptcy Rules require that debtors file a number of schedules describing their financial affairs. Fed. R. Bankr. P. 1007.Back To Text

[138] *See Barker*, 168 B.R. at 780.Back To Text

[139] For a discussion of *Johnson,* see, *supra* notes 114–21 and accompanying text.Back To Text

[140] For a discussion of *Tveten,* see, *supra* notes 81–93 and accompanying text.Back To Text

[141] 104 B.R. 866 (Bankr. S.D. Ohio 1989).Back To Text

[142] *See* Ohio Rev. Code §§ 2329.66(A)(6)(b), 3911.10 (1997) (establishing exemption under statute for debtor's spouse, children, dependents, relatives, and creditors absent fraud); *see also Beckman*, 104 B.R. at 873.Back To Text

[143] *See Beckman,* 104 B.R. at 873–74 (indicating that definition may not be present in statute but case law exists on point).Back To Text

[144] *See id.* at 867.Back To Text

[145] *See id.* at 870.Back To Text

[146] *See id.* at 870–71 (distinguishing between appropriate and fraudulent uses of pre–bankruptcy planning).Back To Text

[147] *See id.* at 871 (analyzing additional factors pointing toward fraud).Back To Text

[148] 189 B.R. 258 (Bankr. N.D.N.Y. 1995).Back To Text

[149] *See id.* at 260.Back To Text

[150] *See id.* at 261.Back To Text

[151] *See id.* at 260.Back To Text

[152] *See id*. at 263.Back To Text

[153] *In re* Moore, 177 B.R. 437, 441 (Bankr. N.D.N.Y. 1994).Back To Text

[154] *See*, *e.g., id.* at 440 (noting that Code allows debtor to choose exemptions under state or federal law and that New York prohibits debtors from choosing Code exemptions).Back To Text

[155] *See* U.S. Const. art. I, § 8, cl. 4.Back To Text

[156] 186 U.S. 181 (1902); *see also* Judith Schenck Koffler, *The Bankruptcy Clause and Exemption Laws*, 58 N.Y.U. L. Rev. 22 (1983). Professor Koffler compares the bankruptcy clause in the Constitution to the tax and naturalization clauses, which also dictate uniformity. *Id.Back To Text*

[157] *See Moyses*, 186 U.S. at 183 (discussing creditor's constitutional challenges to Bankruptcy Act of 1898).Back To Text

[158] *See id*. at 188–90.Back To Text

[159] 173 F. 585 (8th Cir. 1909).Back To Text

[160] *See id.* at 590.Back To Text

[161] *See id.* at 590–91.Back To Text

[162] *Id*. at 591.Back To Text

[163] *See id.* (citing bankruptcy, revenue, and naturalization as areas of law that the controlling political party could manipulate to control geographic pockets of opposition).Back To Text

[164] 13 B.R. 1 (Bankr. S.D. Ohio 1980) (chapter 7 debtor sought to avoid, under section 522(f), certain judicial liens and non–possessory, non–purchase money security interests in certain consumer goods, because they impaired exemptions).Back To Text

[165] *Id.* at 2.Back To Text

[166] *See* 11 U.S.C. § 522(f) (1994).Back To Text

[167] *See Storer,* 13 B.R. at 3–4.Back To Text

[168] *See id.* at 4 (concluding Congress did not give Ohio power to nullify section 522(f)).Back To Text

[169] *See* U.C.C. § 9–203 (1977) (stating security interest attaches after agreement between parties that describes collateral has been signed by debtor).Back To Text

[170] *See Storer,* 13 B.R. at 2–3 (citing H.R. Doc. No. 93–137, 93rd Cong., 1st Sess. (1973)).Back To Text

[171] *See* Commission Report, *supra* note 8, at 125 (proposing elimination of opt out, a range within which the homestead exemption may fall, and a lump sum personal property exemption).Back To Text

[172] *See id.* (discussing necessity to balance conflicting interests of debtors and creditors).Back To Text

[173] *See* 11 U.S.C. § 522 (1994) (permitting choice for debtors between state and federal non–bankruptcy exemptions).Back To Text

[174] *See* Commission Report, *supra* note 8, at 118–19 (discussing different results that occurred because of differing state law exemptions).Back To Text

[175] *See id.* at 125.Back To Text

[176] *See* Woodward, *supra* note 36, at 360–363. Another reason cited by the author for having same exemptions both in and out of bankruptcy is "symmetry," which rests on the belief that the exempt or nonexempt status of the debtor's property "should not vary with the procedures ultimately utilized to obtain it in satisfaction of debt." *See id.* at 354–55. Back To Text

[177] *See* Commission Report, *supra note* 8, at 146 (discussing results of chapter 7 petition); *see also* 11 U.S.C. § 727(a)(1) (stating only individual is entitled to receive discharge in chapter 7 case).Back To Text

[178] *See* Thomas H. Jackson, *Avoiding Powers In Bankruptcy*, 36 Stan. L. Rev. 725, 726 (1984) (discussing difference between preference law and fraudulent conveyance law).Back To Text

[179] *See* 11 U.S.C. § 726(a)(6) (dealing with distribution of estate property).Back To Text

[180] *See* Butner v. United States, 440 U.S., 48, 54–55 (1979) (indicating that absent some federal interest, property interests are created and defined by state law).Back To Text

[181] *See id.* at 54 (stating "Congress has generally left determination of property rights . . . to state law"); *see also* Ponoroff & Knippenberg, *supra* note 71, at 252 (discussing availability of federal and state created exemptions); *cf.* Steven L. Harris, *A Reply to Theodore Eisenberg's Bankruptcy Law in Perspective*, 30 UCLA L. Rev. 327, 329 (1982) (noting debtor's ability to opt for state created exemptions).Back To Text

[182] *See generally* Ponoroff & Knippenberg, *supra* note 71, at 235 (viewing exemptions as central to fresh start concept).Back To Text

[183] *See generally* Cristol, *supra* note 16, at 715 (focusing primarily on problems faced by attorneys advising debtors on pre–bankruptcy planning issues). Back To Text

[184] *See* Brown, *supra* note 29, at 210 (suggesting that bar date approach would lend certainty to outcome but criticizes such approach as not being sufficient disincentive to affluent debtors to prevent pre–bankruptcy planning); *see also* Resnick, *supra* note 9, at 651–653 (advocating amendment to Code under which exemption would be disallowed if debtor acquired property within 90 days before filing a petition in bankruptcy, but only if property acquired exceeded reasonable needs of debtor or his dependents); *see also* Theodore Eisenberg, *Bankruptcy Law in Perspective*, 28 UCLA L. Rev. 953, 991–98 (1981).Back To Text

[185] *See* Harris, *supra* note 181, at 342. Professor Harris criticized Professor Eisenberg's suggestion that all conversions to exempt property during a specified period be presumptively invalid by arguing: "hasn't the debtor who converts his nonexempt assets to exempt assets acted in consonance with the bankruptcy statute? He will have the kind of fresh start that Congress desired. To require a minimum holding period for exempt assets would frustrate that fresh start by delaying or denying it." *Id.Back To Text*

[186] *See id.* at 341.Back To Text

[187] *See* Eisenberg, *supra* note 184, at 995.Back To Text

[188] Under chapter 13, if the trustee or the holder of an allowed unsecured claim objects to the debtor's plan, the court cannot approve the plan unless the debtor applies all of his disposable income to the plan. Disposable income, in the case of a debtor not engaged in business, is defined as "income which is received by the debtor and which is not reasonably necessary to be expended for the maintenance or support of the debtor or a dependent of the debtor." 11 U.S.C. § 1325(b) (1994); *see also In re* Davis, 68 B.R. 205, 210 (Bankr S.D.

Ohio 1986) (discussing requirements of section 1325(b) of Code as "ability to pay" test); *cf. In re* Sturgeon, 51 B.R. 82, 83 (Bankr. S.D. Ind. 1985).Back To Text

[189] *See, e.g., Davis*, 68 B.R. at 205 (Bankr. S.D. Ohio 1986) (questioning debtor's good faith in proposing plan in which $58.00 per month was budgeted for child care when debtor's wife did not work outside home, $50.00 per month was budgeted for books and periodicals, $46.00 was budgeted towards church contributions and $30.00 per month was budgeted for recreation and entertainment); *see also In re* Jones, 55 B.R. 462, 465 (Bankr. D. Minn. 1985) (noting that chapter 13 contemplates that debtor make some sacrifices in making fresh start); *cf. Sturgeon*, 51 B.R. at 83 (discussing reasonably necessary standard).Back To Text

[190] *See supra* Part III and accompanying text. Back To Text

[191] *See* Cristol, *supra* note 16, at 728. Back To Text

[192] *See* Eisenberg, *supra* note 184, at 994. Back To Text

[193] *See* Resnick, *supra* note 9, at 651. Back To Text

[194] *Id.Back To Text*

[195] *See* Ponoroff & Knippenberg, *supra* note 71, at 315–17 (discussing exemption as creating set of property interests in debtor).Back To Text

[196] *See id.* at 315 (explaining deeper analysis possible by reconceptualizing asset conversion outside of prevailing metaphor of transfer).Back To Text

[197] *See id.Back To Text*

[198] *See* Butner v. United States, 440 U.S. 48, 55 (1979) (discussing question of whether security interest in property extends to rents and profits from property can be resolved by reference to state law); *see also* Virginia Nat'l Bank v. Martin (*In re* Martin), 20 B.R. 374, 377 (Bankr. E.D. Va. 1982) (observing Code's respect for property rights originating in nonbankruptcy law); *cf.* Schmidt v. White (*In re* White), 28 B.R. 240, 242 (Bankr. E.D. Va. 1983) (discussing views of several courts with respect to exercise of state created property rights in context of bankruptcy proceeding).Back To Text

[199] *See, e.g.,* Resnick, *supra* note 9, at 615; *see also White*, 28 B.R at 242 (discussing differing rationales for justifying conversion of non–exempt to exempt assets by insolvent debtors); *cf. In re* Schwarb, 150 B.R. 470, 471 (Bankr. M.D. Fla. 1992) (reviewing legislative history of section 522 of Code to reveal concerns voiced by commentators prior to 1978 enactment).Back To Text

[200] *See* Ponoroff and Knippenberg, *supra* note 71, at 302.Back To Text

[201] *See* Harris, *supra* note 181, at 343 (discussing tensions inherent in distribution of assets among creditors); *cf. In re* Davis, 68 B.R. 205, 212 (Bankr. S.D. Ohio 1986) (noting that so called "best efforts" requirements of section 1325(b) will provide at least some payments to unsecured creditors).Back To Text

[202] *See generally* Lynn M. LoPucki, *The Unsecured Creditor's Bargain*, 80 Va. L. Rev. 1887 (1994) (discussing bargains struck by secured and unsecured creditors in their lending practices).Back To Text

[203] *See id.* at 1963.Back To Text

[204] *See In re* Wilson, 123 F. 20, 22 (9th Cir. 1903) (holding that creditors are presumed to know exemption laws); *see also* Schmidt v. White (*In re* White), 28 B.R. 240, 242 (Bankr. E.D. Va. 1983) (reviewing rationales cited by courts to justify use of conversion as inclusive of presumptive knowledge of law by

creditors).Back To Text

[205] *See In re* Rester, 46 B.R. 194, 199 (S.D. Ala. 1984) (noting certain unsecured creditors stand to receive almost nothing from estate due to exemptions); *see also Wilson*, 123 F. at 22 (stating creditors do assume risk of loss due to exemption); *cf. White*, 28 B.R. at 242 (observing many courts hold to theory of assumption of risk on part of creditors).Back To Text

[206] *See* David Frisch, *Remedies as Property: A Different Perspective on Specific Performance Clauses*, 35 Wm. & Mary L. Rev. 1691, 1734 (1994). Professor Frisch addresses whether specific performance should be available to buyers of goods under Article 2 of U.C.C. and highlights fact that enforceable specific performance clauses would result in interest analogous to a secret lien. *See id.Back To Text*

[207] *See* Ponoroff & Knippenberg, *supra* note 71, at 315 (stating that property may be alienated voluntarily or involuntarily, absolutely or for security); *see also In re* Richards, 92 B.R. 369, 371 (Bankr. N.D. Ind. 1988) (observing operative effect of such transfers is disparate treatment of creditors of same class); *cf.* Lasich v. Wickstrom (*In re* Wickstrom), 113 B.R. 339, 349 (Bankr. W.D. Mich. 1990) (discussing inequities created by such property transfers and labeling them as subversive to spirit and mandate of Code).Back To Text

[208] *See Richards*, 92 B.R. at 371 (discussing effect of 11 U.S.C. § 547(b)(5), requiring courts to focus on disparate consequences of voidable preferences upon creditor class); *see also* McCullough v. Garland (*In re* Jackson), 90 B.R. 793, 795 (Bankr. D.S.C. 1988) (listing elements of the voidable preference); *cf.* Aulick v. Largent, 295 F.2d 41, 51 (4th Cir. 1961) (discussing similar preferences).Back To Text

[209] *See In re* Schwarb, 150 B.R. 470, 471 (Bankr. M.D. Fla. 1992) (discussing balancing of debtor and creditor rights under Code); *see also In re* Cordes, 147 B.R. 498, 505 (Bankr. D. Minn. 1992)(reviewing appropriate balancing test for competing rights of debtors and creditors); *cf. Wickstrom*, 113 B.R. at 348 (observing rights of creditors are governed by type of exemptions elected by debtor and specific property exempted).Back To Text

[210] *See* Ponoroff & Knippenberg, *supra* note 71, at 293 (defining honest but unfortunate debtor).Back To Text

[211] 11 U.S.C. §§ 707(b), 1325(a)(3) (1994); *see also In re* Davis, 68 B.R. 205, 209 (Bankr. S.D. Ohio 1986) (discussing section 1325(a)(3) good faith requirement); *cf. Schwarb*, 150 B.R. at 472 (observing case in bankruptcy may be dismissed pursuant to section 707(b) as substantial abuse of provisions of chapter).Back To Text

[212] 11 U.S.C. §§ 523(a), 727(a); s*ee also Schwarb*, 150 B.R. at 472 (noting fraudulent pre−bankruptcy planning may be basis for denial of discharge under section 727(a)(2) of Code); *cf. Davis*, 68 B.R. at 214 (discussing operation of section 523(a)(2) on debtor bad faith).Back To Text

[213] Note that this is an important limitation, since some debtors will shelter as much money as possible in an asset with an unlimited exemption. Also, in section 522(d)(10)(E), the Code limits a debtor's ability to exempt payments under a pension or similar plan only to the extent reasonably necessary for the support of the debtor.Back To Text

[214] Resnick, *supra* note 9, at 621.Back To Text

[215] *See* Schmidt v. White (*In re* White), 28 B.R. 240, 243 (Bankr. E.D. Va. 1983) (discussing purpose of exemption laws); *see also In re* Butts, 45 B.R. 34, 36 (Bankr. D.N.D. 1984) (summarizing legislative comments on purposes of exemption laws); *cf. Schwarb*, 150 B.R. at 472 (describing concerns with respect to limitations on exemption amounts). Back To Text

[216] *See* Traer v. Clews, 115 U.S. 528, 541 (1885) (including fresh start as underlying policy of Bankruptcy Act of 1867); *see also In re* Neiheisel, 32 B.R. 146, 157 (Bankr. D. Utah 1983) (discussing fresh start concept

with respect to corresponding state and federal exemptions); *cf.* Stellwagen v. Clum, 245 U.S. 605, 617 (1918) (opining Federal bankruptcy system was designed to effectuate debtor's fresh start).Back To Text

[217] Koffler, *supra* note 156, at 30–32.Back To Text

[218] *See* Wetmore v. Markoe, 196 U.S. 68, 77 (1904) (stating bankruptcy was designed to relieve honest debtor from oppressive indebtedness); *see also* Financial Security Assurance v. T–H New Orleans Ltd. Partnership (*In re* T–H New Orleans Ltd. Partnership), 116 F.3d 790, 798 (5th Cir. 1997) (observing equitable nature of bankruptcy in seeking to balance opposing interests in discharge proceedings); *cf. In re* Patio & Porch Sys., Inc., 194 B.R. 569, 575 (Bankr. D. Md. 1996) (discussing court's broad discretion with respect to balancing of debtor and creditor interests).Back To Text

[219] *See* Lasich v. Estate of Wickstrom (*In re* Wickstrom), 113 B.R. 339, 349 (Bankr. W.D. Mich. 1990) (explaining fundamental purpose of bankruptcy is to distribute property pro–rata among creditors); *see also In re* Winter, 151 B.R. 278, 282 (Bankr. W.D. Okla. 1993) (finding best interest of creditors' test as determinative of plan of reorganization). Back To Text

[220] Koffler, *supra* note 156, at 32.Back To Text

[221] *See* 11 U.S.C. § 507 (1994) (specifying claims entitled to priority in distribution); *id.* § 726 (discussing order for distributing property of estate).Back To Text

[222] Koffler, *supra* note 156, at 33 (noting exemptions regulate consumer credit system by discouraging excessive credit and promoting credit extensions consistent with national policy).Back To Text

[223] *See* Traer v. Clews, 115 U.S. 528, 541 (1885) (naming fresh start as goal of bankruptcy); *see also* Wetmore v. Markoe, 196 U.S. 68, 77 (1904) (same reasoning); *cf. In re* Neiheisel, 32 B.R. 146, 148 (Bankr. D. Utah 1983) (discussing fresh start policy as primary function of bankruptcy law).Back To Text

[224] *See Neiheisel*, 32 B.R. at 155 (detailing conflicting policies behind state exemption laws); *see also* Dionne v. Harless (*In re* Harless), 187 B.R. 719, 726–31 (Bankr. N.D. Ala. 1995) (noting differing state policies with respect to exemptions); *cf. In re* Rester, 46 B.R. 194, 199 (S.D. Ala. 1984) (discussing differences between Alabama and federal exemptions).Back To Text

[225] *See* Schlein v. Mills (*In re* Schlein), 8 F.3d 745, 748 (11th Cir. 1993) (finding chapter 7 debtor could exempt IRAs from bankruptcy estate); *see also Harless*, 187 B.R. at 727–29 (examining exemption of retirement accounts); *cf.* American Honda Fin. Corp. v. Cilek (*In re* Cilek), 115 B.R. 974, 986 (Bankr. W.D. Wis. 1990) (suggesting fresh start assures debtor that future assets to which he may become entitled will be free of any pre–bankruptcy obligations).Back To Text

[226] *See Neiheisel*, 32 B.R. at 157 (explaining fresh start doctrine expresses both humanitarian and economic concerns); *see also Cilek*, 115 B.R. at 986 (reviewing far reaching effects of fresh start theory); *cf. In re* Shaker, 137 B.R. 930, 953 (Bankr. W.D. Wis. 1992) (applying fresh start concept to ERISA pension benefits).Back To Text

[227] *See In re* Schwarb, 150 B.R. 470, 473 (Bankr. M.D. Fla. 1992) (discussing eve of bankruptcy transfers); *In re* Butts, 45 B.R. 34, 36 (Bankr. D.N.D. 1984) (detailing debtor's right to make full use of exemptions given by law); *see also* Schmidt v. White (*In re* White), 28 B.R. 240, 242 (Bankr. E.D. Va. 1983) (explaining debtor's right to exemptions of pre–bankruptcy assets).Back To Text

[228] *See* 11 U.S.C. § 525(b) (1994) (prohibiting employer from terminating employee if employee is debtor, has been insolvent, or has not been paid dischargeable debt).Back To Text

[229] *See id.* § 525(a) (outlining situations where governmental unit may not deny debtor licenses, permits and other similar grants).Back To Text

[230] *See In re* Merriweather, 185 B.R. 235, 238 (Bankr. S.D. Tex. 1995) (concluding mortgage company's refusal to refinance chapter 7 debtor's mortgage did not violate bankruptcy discrimination provisions); *In re* Rose, 23 B.R. 662, 668 (Bankr. D. Conn. 1982) (rejecting debtor's claim of discrimination due to denial of mortgage post bankruptcy); *see also In re* de Kleinman, 136 B.R. 69, 73 (Bankr. S.D.N.Y. 1991) (refusing to force landlord to offer lease to postpetition debtor).Back To Text

[231] *See* Ponoroff & Knippenberg, *supra* note 71, at 322 (discussing property interests involved on eve of bankruptcy conversions); *see also* Lasich v. Estate of Wickstrom (*In re* Wickstrom), 113 B.R. 339, 348 (Bankr. W.D. Mich. 1990) (discussing effect of exemptions upon creditors' rights); Schmidt v. White (*In re* White), 28 B.R. 240, 242 (Bankr. E.D. Va. 1983) (reviewing right to exemptions and effect upon creditors).Back To Text

[232] 13 F. Cas. 1082 (N.D. Ga. 1874).Back To Text

[233] *See id.* at 1083. For a discussion of the context of this case, see Koffler, *supra* note 156, at 102.Back To Text

[234] For a history of the preference laws, see Vern Countryman, *The Concept of a Voidable Preference in Bankruptcy*, 38 Vand. L. Rev. 713, 715–725 (1985).Back To Text

[235] *See* Jackson & Kronman, *Voidable Preferences and Protection of the Expectation Interest*, 60 Minn. L. Rev. 971, 971 (1976) (analyzing avoidance powers characterized as "preferences").Back To Text

[236] *See id.* at 987–989 (discussing preference provision as striking balance between unlimited protection and complete invalidation).Back To Text

[237] *See* 5 Collier, *supra* note 1, ¶ 547.01, at 547–49 (discussing section 547(b)); *see also* McCullough v. Garland (*In re* Jackson), 90 B.R. 793, 795 (Bankr. D.S.C. 1988) (discussing voidable preferences under section 547(b) of Code); *cf.* Van Iderstine v. National Discount Co., 227 U.S. 575, 582 (1913) (discussing distinction between fraudulent conveyance and valid preferential transfer). Back To Text

[238] *See* Countryman, *supra* note 234, at 748 (rejecting theory that purpose of preference concept is deterrence).Back To Text

[239] 11 U.S.C. § 726(a)(6) (1994) (placing debtor as last priority in distribution of estate). Back To Text

[240] *See id.* § 547(b). *See generally* Sicherman v. General Highway Express, Inc. (*In re* Service Bolt & Nut Co.), 98 B.R. 759 (N.D. Ohio 1989) (stating debtor's intent in entering preference is irrelevant to trustee's ability to avoid it). Note that under the Bankruptcy Act, the creditor's intent was relevant in the determination of whether a preferential transfer was avoidable. *See* Van Iderstine v. National Discount Co., 227 U.S. 575, 582 (1913) (distinguishing between debtor's intent and effect of his actions on creditors). Back To Text

[241] *See* Countryman, *supra* note 234, at 748 (noting transfers distorting policy do so without regard to state of mind of preferred creditor or debtor).Back To Text

[242] *See Van Iderstine*, 227 U.S. at 582 (finding defendant creditor did not have knowledge of intent to defraud when debtor borrowed money to pay off debt).Back To Text

[243] 227 U.S. 575 (1913).Back To Text

[244] *See id*. at 582 (discussing difference between intent to defraud and intent to prefer).Back To Text

[245] *Id.*Back To Text

[246] *See id.* ("A fraudulent conveyance is void regardless of its date; a preference is valid unless made within the prohibited period.").Back To Text

[247] 70 F.2d 479 (10th Cir. 1934).Back To Text

[248] *See id*. at 481–82.Back To Text

[249] *See generally* 11 U.S.C. § 547 (1994).Back To Text

[250] *See id.* § 547(b).Back To Text

[251] *Id.* § 101(54).Back To Text

[252] *See, e.g.,* Ford v. Poston (*In re* Ford), 773 F.2d 52, 54–55 (4th Cir. 1985) (finding debtor's transfer of real property constituted fraudulent transfer, since debtor transferred property one day after creditor obtained judgment). In the preference analysis, it is necessary to focus on the acquisition of the exempt property. Back To Text

[253] Unif. Fraudulent Transfer Act § 1(12) (1985) (emphasis added).Back To Text

[254] *Id.* § 1(2). The term "asset" does not include "property to the extent it is generally exempt under nonbankruptcy law." *Id.* According to the official comment accompanying section 1, such a definition of an asset helps to protect exemption statutes by limiting the rights and remedies of unsecured creditors in order to ensure that such property interests remain out of reach of unsecured creditors. The comment explains:

> [t]he reference to generally exempt property in § 1(2)(ii) recognizes that all exemptions are subject to exceptions. Creditors having special rights against generally exempt property typically include claimants for alimony, taxes, wages, the purchase price of the property, and labor or materials that improve the property. See Uniform Exemption Act § 10 and the accompanying Comment. The fact that a particular creditor may reach generally exempt property by resorting to judicial process does not warrant its inclusion as an asset in determining whether the debtor is insolvent.

Id. Comment 2.Back To Text

[255] The amount of property in the estate also provides the floor for plan payments in a chapter 11 or chapter 13 case. *See* 11 U.S.C. §§ 1129(a)(7), 1325(a)(4).Back To Text

[256] *Id.* § 101(10).Back To Text

[257] *Id.* § 101(15).Back To Text

[258] *See id.* § 101(5) (defining "claim").Back To Text

[259] *See id.* § 547(b)(5); *see also* 5 Collier, *supra* note 1, ¶ 547.03, at 547.Back To Text

[260] 11 U.S.C. § 506(a).Back To Text

[261] *See id.* § 507 (specifying claims entitled to priority in distribution); *see also id.* § 726 (dictating order in which property of estate is distributed).Back To Text

[262] *See* Committee of Creditors Holding Unsecured Claims v. Koch Oil Co. (*In re* Powerine Oil Co.), 59 F.3d 969, 972 (9th Cir. 1995) (noting because creditor was beneficiary of letter of credit, which would have allowed it full recovery of its claim from third party issuer, creditor would not have received full payment *from estate*, so debtor's prepetition payment to creditor was preferential) (emphasis added); *see also* Smith v. Creative Fin. Management, Inc. (*In re* Virginia–Carolina Fin. Corp.), 954 F.2d 193, 199 (4th Cir. 1992) (focusing on whether creditor would have received less than 100% payout in chapter 7 liquidation in applying section 547, which authorizes trustee to avoid any transfer of debtor's interest in property, enabling creditor to receive "more than" he would receive in such proceeding).Back To Text

[263] *See, e.g.,* LoPucki, *supra* note 202, at 1887 (arguing that security misallocates resources by "imposing on unsecured creditors a bargain to which many, if not most, of them have given no meaningful consent").Back To Text

[264] *See* 11 U.S.C. § 506 (describing determination of secured status). According to section 506 of the Code, an allowed claim, which is secured by a lien on the estate's property, is a secured claim "to the extent of the value of such creditor's interest in the estate's interest in such property." *See id.* § 506(a). This section gives the secured creditor the value of its property rights but not the *in rem* rights such as the right to seize the collateral. *See* United Sav. Ass'n v. Timbers of Inwood Forest Assoc., 484 U.S. 365, 371–72 (1988) (discussing interrelationship between section 506(a) and section 365(d)(1)); *see also* Margaret Howard, *Secured Claims in Bankruptcy: An Essay on Missing the Point*, 23 Cap. U. L. Rev. 313, 318 (1994) (discussing how *Dewsnup v. Timm* departs from rule of entitling secured creditor to value of its property rights and not to *in rem* rights).Back To Text

[265] Perfection is defined as "[i]n secured transactions law, the process whereby a security interest is protected, as far as the law permits, against competing claims to the collateral, which usually requires the secured party to give public notice of the interest as by filing in a government office." Black's Law Dictionary 1137 (6th ed. 1990). A trustee in bankruptcy may avoid an unperfected security interest pursuant to the Code's "strong–arm" power. Section 544(a) provides:

> (a) The trustee shall have, as of the commencement of the case, and without regard to any knowledge of the trustee or of any creditor, the rights and powers of, or may avoid any transfer of property of the debtor or any obligation incurred by the debtor that is voidable by—
>
> (1) a creditor that extends credit to the debtor at the time of the commencement of the case, and that obtains, at such time and with respect to such credit, a judicial lien on all property on which a creditor on a simple contract could have obtained such a judicial lien, whether or not such a creditor exists;
>
> (2) a creditor that extends credit to the debtor at the time of the commencement of the case, and obtains, at such time and with respect to such credit, an execution against the debtor that is returned unsatisfied at such time, whether or not such a creditor exists; or
>
> (3) a bona fide purchaser of real property, other that fixtures, from the debtor, against whom applicable law permits such transfer to be perfected, that obtains the status of a bona fide purchaser and has perfected such transfer at the time of the commencement of the case, whether or not such a purchaser exists.

11 U.S.C. § 544(a) (1994).Back To Text

[266] For instance, a purchase money security interest in consumer goods is automatically perfected at the time that the security interest attached and a security interest in negotiable instruments can be temporarily perfected without possession. *See* U.C.C. §§ 9–302(d), 9–303.Back To Text

[267] *See id.* § 9–302. To perfect a security interest in real property, the creditor must record its mortgage in the office of the recorder of deeds in the county in which the land is located. *See, e.g.,* N.J. Stat. Ann. § 46:22–1; Ariz. Rev. Stat. § 33–411; N.Y. Real Prop. Law § 291. Back To Text

[268] *See* U.C.C. § 9–305 (providing that security interest in goods may be perfected by secured party's taking possession of collateral).Back To Text

[269] *See*, *e.g.*, N.J. Stat. .Ann. 39:10–14; 75 Pa. Cons. Stat. § 1106; NY Unif. Veh. Cert. of Title Act § 2118. *Back To Text*

[270] *See* 11 U.S.C. § 547(e) (1994) (determining when transfer is made for purposes of preference section); U.C.C. § 9–203 (describing attachment and enforceability of security interests).Back To Text

[271] See 11 U.S.C. § 522(d), which gives the debtor the right to exempt a portion of "the debtor's interest" in the listed property.Back To Text

[272] *See* U.C.C. § 9–203(1).Back To Text

[273] This was one of the creditor's arguments in *Up State Fed. Credit Union v. Carletta* (*In re Carletta*), 189 B.R. 258, 260–61 (Bankr. N.D.N.Y. 1995). Creditors contended that by allowing debtors to transfer all of their non–exempt property into a vehicle that enjoys an unlimited exemption under state law will result in the extinction of the chapter 7 'asset' case. *See id.* Back To Text

[274] 11 U.S.C. § 547(c)(5). Such a lien on inventory is avoidable if it satisfies the requirements of a preference and causes the secured creditor to improve its position with regard to its loan to security ratio. *See id.Back To Text*

[275] 11 U.S.C. § 101(12).Back To Text

[276] *See id.* § 547(f); *see also* S. Rep. No. 95–989, at 89 (1978), *reprinted* in 1978 U.S.C.C.A.N. 5787, 5875 (requiring party against whom presumption exists to come forward with some evidence to rebut presumption—but burden of proof remains on party where favor of presumption exists).Back To Text

[277] 11 U.S.C. § 101(32).Back To Text

[278] Unif. Fraudulent Transfer Act § 2(b) (1984).Back To Text

[279] 11 U.S.C. § 303(h). If a debtor against whom an involuntary petition has been filed challenges the petition, one of the grounds on which the court shall order relief is that the debtor is generally not paying debts as they become due. *See id.Back To Text*

[280] *See* 11 U.S.C. § 547(b)(4).Back To Text

[281] *See id.* § 101(31) (defining insider).Back To Text

[282] *See id.Back To Text*

[283] *See id.* Back To Text

[284] *See generally id.* § 550 (defining liability of transferee of avoided transfer). Back To Text

[285] *See generally* 11 U.S.C. § 547(c) (defining when trustee may not avoid transfer as preference).Back To Text

[286] *See* Ponoroff & Knippenberg, *supra* note 71, at 316 (discussing definition of "Exemption Property"); Resnick, *supra* note 9, at 646–52; Harris, *supra* note 181, at 342 (justifying pre–bankruptcy asset conversion by stating that in section 522, "Congress determined an appropriate standard of post–bankruptcy living with both the amounts and types of property that it thought would facilitate a successful fresh start.").Back To Text

[287] *See* 11 U.S.C. § 522(d)(9).Back To Text

[288] *Id.* § 547(c)(1). Back To Text

[289] *See id.* § 547(c)(2) (protecting transfers in ordinary course of business).Back To Text

[290] *In re* Schwarb, 150 B.R. 470, 471 (Bankr. M.D. Fla. 1992) (quoting *Hearings on H.R. 31 and H.R. 32 before Subcomm. on Civil and Constitutional Rights of the Comm. on the Judiciary*, 94th Cong. (1976)). *See* Wudrick v. Clements, 451 F.2d 988, 989 (9th Cir. 1971) (stating that rule allows conversion of nonexempt assets to exempt assets on eve of bankruptcy); *In re* Spoor–Western, Inc., 139 B.R. 1009, 1014–15 (Bankr. N.D. Okla. 1992) (discussing letter from Bankruptcy Judge Phelps strongly condemning pre–bankruptcy planning).Back To Text

[291] *See Hearings on H.R. 31 and H.R. 32 before the Subcomm. on Civil and Constitutional Rights of the Comm. on the Judiciary*, 94th Cong. (1976) (Letter from Judge Phelps, Bankruptcy Judge) [hereinafter Phelps Letter]; *see also Spoor–Western*, 139 B.R. at 1014–15 (discussing letter). Back To Text

[292] Phelps Letter, *supra* note 291. Back To Text

[293] Even under the fraudulent transfer analysis, there is a one–year window. This applies when the creditor or trustee is arguing that the discharge should be denied under 11 U.S.C. § 727(a)(2). However, section 544(b) of the Code gives the trustee the ability to use applicable state law, such as a state's version of the UFTA to avoid a fraudulent transfer provided that there was an actual creditor who could have avoided the transfer. Such a transfer may be avoided in some cases if it were made within four years of the bankruptcy filing. *Id.* § 544(b), 727(a)(2). *See generally*, 5 Collier, *supra* note 1, ¶ 544.09, at 544. Back To Text