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CONCURRENT SESSION

Consumer

Pre-Bankruptcy Planning in the Consumer Case

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2019

INFORMATION ACQUISITION – HOW TO GET BLOOD FROM A STONE

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I. DEBTOR'S COUNSEL'S DUE DILIGENCE OBLIGATIONS UNDER THE BANKRUPTCY CODE – WHAT YOU ARE SUPPOSED TO DO AND WHAT CAN HAPPEN IF YOU DON'T

The Bankruptcy Code imposes a duty on debtor's counsel to ensure accuracy in the Schedules and Statements filed in a bankruptcy proceeding. This duty is codified in Bankruptcy Code Section 707(b)(4)(C) as follows:

> "The signature of an attorney on a petition, pleading, or written motion shall constitute a certification that the attorney has—
>
> **(i)** performed a reasonable investigation into the circumstances that gave rise to the petition, pleading, or written motion; and
>
> **(ii)** determined that the petition, pleading, or written motion—
>
> **(I)** is well grounded in fact; and
>
> **(II)** is warranted by existing law or a good faith argument for the extension, modification, or reversal of existing law and does not constitute an abuse under paragraph (1)."

In cases where the Debtor's obligations are primarily consumer debts, Debtor's counsel must also sign a certification on page 7 of the Voluntary Petition as follows:

> "I, the attorney for the debtor(s) named in this petition, declare that I have informed the debtor(s) about eligibility to proceed under Chapter 7, 11, 12, or 13 of title 11, United States Code, and have explained the relief available under each chapter for which the person is eligible. I also certify that I have delivered to the debtor(s) the notice required by 11 U.S.C. § 342(b) and, in a case in which § 707(b)(4)(D) applies, certify that I have no knowledge after an inquiry that the information in the schedules filed with the petition is incorrect."

Courts acknowledge that the certification is not a "guaranty" of the veracity of the information. However, debtor's counsel must nevertheless make inquiry and cannot merely

accept the information a debtor provides and incorporate the information into the bankruptcy forms without question.

> "Accordingly, any attorney who files schedules and statements on a debtor's behalf makes a certification regarding the representations contained therein. Although the certification is not an absolute guaranty of accuracy, it must be based upon the attorney's best knowledge, information and belief, "formed after an inquiry reasonable under the circumstances." Nosek v. Ameriquest Mortg. Co. (In re Nosek), 386 B.R. 374, 381 (Bankr. D. Mass. 2008). The First Circuit has held that the standard to be applied is "an objective standard of reasonableness under the circumstances." Id. (quoting Cruz v. Savage, 896 F.2d 626, 631 (1st Cir. 1990)). "Courts, therefore, must inquire as to whether 'a reasonable attorney in like circumstances could believe [**15] his actions to be factually and legally justified.'" Id. (quoting Cabell v. Petty, 810 F.2d 463, 466 (4th Cir. 1987)). Lafayette v. Collins (In re Withrow), 405 B.R. 505, 512 (B.A.P. 1st Cir. 2009):

Bankruptcy Code Section 704(b)(4)(C) must be read together with Bankruptcy Rule 9011 which imposes similar duties on all lawyers and in a broader context. Courts considering the interplay between the Rule 9011 and Section 704(b)(4)(C) generally agree that Section 704 enhances the requirements in Rule 9011. Together, the provisions require counsel to conduct an independent inquiry when information provided by the client is cause for concern. This duty of investigation may best be summarized as follows:

> "The "reasonable investigation" under this section is indistinct from the "reasonable inquiry" under Rule 9011. To comply with Section 707(b)(4)(C), the attorney must perform an objectively reasonable investigation into the circumstances [**125] giving rise to the petition, assessed at the time the petition was filed. 11 U.S.C. § 707(b)(4)(C) (2012). The attorney cannot take all of the client's assertions at face value nor rely solely upon the information provided by the client. The attorney may rely on her client's objectively reasonable assertions, but where the client-provided information is internally (or externally) inconsistent, materially incomplete, or raises "red flags," the attorney is obligated to probe further — by asking questions, obtaining additional documents, or by some other means. Again, the attorney is the expert and cannot rely upon a client's limited understanding of what constitutes the "complete" or "necessary" information that the attorney must have nor what information is or is not relevant to the client's particular situation. Dignity Health v. Seare (In re Seare), 493 B.R. 158, 211 (Bankr. D. Nev. 2013)

Some Courts have extended this duty of investigation to include public records:

> "Furthermore, Defendants have a duty to "independently verify publicly available facts to determine if the client representations are objectively reasonable." *See In re Parikh*, 508 B.R. at 585-86 (citing *Hadges v. Yonkers Racing Corp.*, 48 F.3d 1320, 1329-30 (2d Cir.1995). Although Defendants met with Plaintiff numerous times and had every opportunity to verify the information on the forms, they failed to do so." Lindo v. Figeroux (In re Lindo), 2015 U.S. Dist. LEXIS 169474, at *19 (S.D.N.Y. Dec. 18, 2015)

Moreover, Courts may impose harsh penalties on attorneys that do not fulfil their duties, including sanctions requiring fee disgorgement or a multiple thereof[1], and suspending filing privileges and ordering attendance at remedial bankruptcy courses[2].

[1] See Gargula vs. Bisges (In re Clink), 2013 Bankr. Lexis 1663 (Bankr. W.D. MO. 2013), where the court entered sanctions order requiring counsel to pay three times the amount of the fee collected.
[2] See In re Moffett, 2012 Bankr. Lexis 824, (Bankr. C.D. Ill., 2012) where the court suspended counsel's filing privileges for one year and ordered counsel to take four hours of continuing education courses.

II. THE DUE DILIGENCE PROCESS

Proper preparation and presentation of bankruptcy schedules and statements can best be summarized by three words: Disclose, Disclose, Disclose.[3] Expressed another way, consumer lawyers must adopt the unofficial slogan of the great State of Missouri that appears on its license place– "Show Me"! This approach is necessitated by the adoption of the broadest possible definition of "Property of the Bankruptcy Estate" in Section 541 of the Bankruptcy.[4] In practice, the due diligence process can get dicey – you may need information that is in the control of a third party (i.e. relative or friend) that the debtor does not want to involve due to embarrassment or perceived hardship that the disclosure process will entail for the third party; the information may concern property rights of the debtor that might also impact the property rights of non-debtor third parties; the debtor may simply have forgotten important information, or refrain from disclosure due to embarrassment, this latter problem being particularly acute in joint bankruptcy cases where one of the spouses may be learning of the depth of the couple's financial predicament for the very first time. Debtor's counsel must be very alert to any stress or discomfort that the client may be projecting during the information gathering process in order to be able to promptly address the source of anxiety and, in many cases, resolve the problem with little or no adverse consequence to the client.

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[3] "In failing to make the proper disclosures, the Defendant has acted in a manner antithetical to the spirit of the Bankruptcy Code. The three most important words in the bankruptcy system are: disclose, disclose, disclose." Sanchez v. Ameriquest Mortg. Co. (In re Sanchez), 372 B.R. 289, 305 (Bankr. S.D. Tex. 2007)

[4] Property of the estate which includes, with some exceptions, all "legal or equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C. § 541(a). "Congress enacted § 541 as part of the Bankruptcy Reform Act of 1978 intending the definition of property of the estate to be construed broadly to include practically every conceivable interest a debtor may have in property as of the bankruptcy filing date." In re Minton, 348 B.R. 467, 472 (Bankr. S.D. Ohio 2006)

Practical guidelines to ensure compliance with current due diligence requirements will include the following-

a. **Schedule A/B** – Insist on source documents – do not accept the debtor's statement about property interests or property valuations. Many debtors are confused about both the nature and extent of their ownership interest in real and personal property and the value of that interest. The time frame of the inquiry is also very important. When inquiring about real property, the inquiry should cover all real property whenever and wherever owned – do not limit the inquiry period to a shorter time frame - so as not to miss any potential issues relating to past property ownership interests and issues relating to the disposition thereof. Many Bankruptcy Trustees will inquire about any real estate **ever** owned by the debtor **anywhere** so there is no reason not to be prepared in advance. Always check the land registry records for the jurisdiction where the client's real property is located to confirm the nature of the client's ownership interest, lien claims and applicable exemptions. Remember that financial account balances are measured on the date of filing – obtain a snapshot for all accounts to verify balances. Insist on seeing insurance policies and car titles and/or car loan documents to verify ownership. These are just a few examples of source documents you will want to obtain during the due diligence process.

b. **Schedule D, E/F, G and H** – Credit Reports are a good starting point but rarely tell the whole story because creditors may not report delinquencies. Creditor

constituencies that typically do not appear on Credit Reports include medical vendors, taxing authorities, loans from friends and family, claims asserted in pending litigation, and debt relating to a trade or business.

Debt is frequently bundled and sold and resold and resold….. Insist on copies of any papers relating to any debt to ensure that all creditors, collection agencies and law firms are notified of the filing. This is the debtor's best opportunity to stop all the harassing phone calls and letters and clear out all debt so counsel must strive to provide the broadest notice possible. Moreover, failure to notify a creditor of the bankruptcy filing, even in so called "No Asset" Chapter 7 cases, can have disastrous consequences because in some Circuits[5], omitted creditors are not discharged absent timely amendment to the bankruptcy filing to add the inadvertently omitted creditor.

Carefully review all creditor documents for co-obligors so that the impact of the debtor's filing on non-debtor third parties can be carefully evaluated and a plan devised to address the impact. Indeed, the impact on non-debtor third parties could be very detrimental and cause severe financial distress setting off a chain reaction of subsequent bankruptcy filings by the no-debtors. Co-debtor obligations must be fully vetted before any bankruptcy case is filed.

[5] See Colonial Surety Company v. Weisman, 564 F. 3d 526,530 (1st Cir. 2009) "… if the debtor fails to list a supposed creditor's claim--meaning that the creditor will not be notified of the opportunity to participate in the proceeding (and the creditor does not otherwise happen to know of the bankruptcy), the debt is not discharged. See also Stone v. Caplan (In re Stone), 10 F.3d 285, 291 (5th Cir. 1994); Samuel v. Baitcher (In re Baitcher), 781 F.2d 1529, 1534 (11th Cir. 1986); Stark v. St. Mary's Hosp. (In re Stark), 717 F.2d 322, 324 (7th Cir. 1983).

Creditor information tends to be much more burdensome to gather and analyze when the debtor is engaged in business. A careful walk through of the debtor's business premises and explanation of the business operations should greatly enhance counsel's ability of identify and properly classify creditor claims. Business records, such as recent Profit and Loss Statements, Tax Returns and Balance Sheets can also provide valuable insight into the nature and amount of business debt.

c. **Schedules I and J** – There is no substitute for copies of pay stubs and a thorough understanding of each and every deduction and the duration of the deduction. For instance, a deduction may appear on a pay check stub for a car loan that is nearing the end of its term. Might the debtor be over-withholding as a means of forced savings in an effort to generate a large tax refund? Always be alert to signs of "unreported income".

Debtors invariably struggle when asked to forecast monthly expenses. Typically, a review of the debtor's checkbook and/or activity on debit cards or credit card statements is most helpful. A useful maxim to remember in the chapter 7 context is that for most Chapter 7 debtors, monthly expenses cannot exceed monthly income – credit privileges are usually no longer available by the time the debtor is visiting your office for the first time – unless the debtor is getting help from a third party or has sources of income that have not been disclosed or is "off the books".

d. **Selected questions on the Statement of Financial Affairs** –

   a. Questions 2, 3, 4, 5 and 15 – obtain tax returns for three year period preceding the bankruptcy filing and year to date pay stubs or other evidence of current year's income.

   b. Questions 6, 7, 8, 14, 15, 16, 17 and 18 - obtain two years of checking account statements and check images

   c. Questions 9,10, 11 and 12 – obtain copies of all court pleadings to determine claims made by or against the debtor and to be able to prepare necessary Notices for filing with the applicable federal of state court to stay proceedings pending the outcome of the bankruptcy filing.

III. CONCLUSION

Careful questioning and insistence on source documentation to support that information contained in Bankruptcy Schedules will enable debtor's counsel to fulfill its role in the due diligence process and ensure a successful outcome for the debtor.

PARTICULARLY PRICKLY PRE-PETITION PROBLEMS

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I. MYSTERIOUS ASSETS

Litigation Recoveries – Pending personal injury recoveries can be very complex and, for that reason, difficult to evaluate. Proper identification of the nature and scope of the recovery is essential to selecting the most advantageous exemption scheme and protect the recovery for the debtor. If the debtor is pursing the claim pre-petition, carefully review the matter with any professionals that may have already been engaged by the debtor to explain the impact that a bankruptcy filing may have on their continued employment and that control of the recovery process and any pending litigation may pass to a Bankruptcy Trustee. If the debtor has yet to taken steps to pursue the claim, engage a professional that can provide you with an assessment of possible outcomes.

Bankruptcy schedules require that the debtor place a value on all assets. Careful thought must be given to the value, if any, placed on pending litigation recoveries because the value listed on the bankruptcy schedule, constituting a sworn statement of the debtor, should be binding on the debtor and could establish a ceiling on recovery possibilities at a later stage in the recovery process.

Further complicating the analysis of this asset class, and perhaps as a result of larger numbers of people undergoing increasingly complex medical procedures, many debtors to not

even know that they have a claim to assert at the time of case commencement, only suffering complications and/or learning of pending or planned class action litigation after the bankruptcy filing. Counsel must check to ensure that the debtor has not received any notifications of any kind in connection with any past medical procedures, or otherwise believes that a recovery of some kind might arise in the future. Many potential recoveries are simply unknowable at the time of case commencement. Fortunately, bankruptcy schedules may be amended as a matter of course[6] until case closing. After case closing, if a case is then re-opened, some courts continue to permit amendment as a matter of course[7] while other courts require a showing of excusable neglect[8].

Trust Property - Trust interests are particularly vexing. Gathering all documents relating to the Trust, which could include the Trust Document and any amendments thereto, Beneficiary Schedules, tax returns, bank account statements and asset inventories, can be problematic if the Trust was not established by the Debtor and the non-debtor is unwilling to cooperate, In some cases, the debtor may be wholly unaware of the Trust and/or their interest in the trust res. For this reason, it is recommended that counsel require debtors to confer with parents and close relatives about possible trust interests.

Assuming the debtor is aware of an interest in trust property, the following line of questioning should enable you to gather information necessary to determine the nature and extent of the debtor's interest in trust property and then analyze the impact that a bankruptcy filing may have on that interest.

i. What is the debtor's interest in the trust: trustee, beneficiary, settlor?

[6] See Bankruptcy Rule 1009(a)
[7] See In re Muscato, 582 B.R. 599 (Bankr. W.D.N.Y, 2018)
[8] See Bankruptcy Rule 9006(b)(1). See also In re Benjamin, 580 B.R.115 (Bankr. D. N.J. 2018)

ii. Is the trust revocable or irrevocable?

iii. If the Debtor is a trustee of the trust, does the trust grant the Debtor discretionary powers over trust assets, powers of revocation, amendment, to appoint beneficiaries or to use trust property or its proceeds for his benefit? If so, the bankruptcy trustee may be able to exercise these powers to reach the trust property for the benefit of bankruptcy estate. The trust property may be then be deemed an asset of debtor under Section 541.

iv. If the Debtor is a beneficiary, is there a spendthrift clause in the trust and is it valid under applicable state law as specified in the trust instrument? If not, the bankruptcy trustee may be able to reach the Debtor's interest in the trust for the benefit of the bankruptcy estate.

v. If the Debtor is a beneficiary and there is a spendthrift clause in the trust, was the Debtor the settlor of the trust? If so, the bankruptcy trustee may be able to reach the Debtor's interest in the trust for the benefit of the bankruptcy estate, notwithstanding the spendthrift clause under state law and under Section 548 of the Bankruptcy Code.

vi. If the Debtor is a beneficiary and there is a spendthrift clause in the trust, and the Debtor was the settlor of the trust, but the trust is governed by a domestic asset protection trust statute, it may be difficult for the bankruptcy trustee to reach the trust assets for the benefit of the bankruptcy estate. However, counsel should determine whether the trust meets all of the requirements of the domestic asset protection trust statute.

vii. In any of the above scenarios, if the Debtor is the settlor of the trust, regardless of whether the Debtor is a beneficiary or trustee of the trust or whether there is a spendthrift clause in the trust, the Debtor's transfer of his or her assets into the trust may be a fraudulent transfer avoidable under state or federal law fraudulent transfer statutes.

viii. If the Debtor is a beneficiary and there is a spendthrift clause in the trust, and the Debtor was not the settlor of the trust, it may be difficult for the bankruptcy trustee to reach the trust assets for the benefit of the bankruptcy estate.

ix. If the Debtor is the trustee and beneficiary under the trust and there are no other trustees or beneficiaries, there may be a merger under applicable state law such that the trust form may be disregarded and the Debtor be found to be the owner of the trust property free and clear of any restrictions contained in the trust.

Business Interests –The impact of a bankruptcy filing on the property rights of a debtor engaged in business is often overlooked. Debtors typically do not want their personal bankruptcy filing to have a disruptive impact on their business (assuming the business is not a/the cause of the personal bankruptcy and the business is continuing to operate). However, the debtor's interest in the business, be it in the form of stock or membership interest if the business is incorporated, or directly in assets of the business because the debtor is operating as a d/b/a, is property of the estate subject to sale by the bankruptcy trustee. Moreover, there may be shareholder agreements in place with transfer restrictions that may be enforceable and could limit the power of the Trustee to administer the debtor's interest in the business[9]. Valuation of the business interest is essential and may require retention of a valuation expert and/or accountant. The valuation process may also provide insight into the likelihood that the asset, if saleable by the Bankruptcy Trustee, is likely to generate any interest from a third party, or another shareholder, if any, of the business.

Inheritances – Always inquire about any inheritance that the debtor may have ever received, and the likelihood that the debtor may inherit property 180 days after case commencement, because these types of property may be subject to administration by the Bankruptcy Trustee. If an inheritance under a Will from a third party is imminent, there is nothing preventing the third party, assuming the testamentary capacity to do so, from modifying

[9] In re Gregerson, 311 B.R. 857 (Bankr. N.D. Iowa 2004)

a Will and disinheriting the debtor[10]. Counsel must also pay careful attention to inherited retirement assets. The Supreme Court has ruled that Inherited Individual Retirement Accounts are not protected by the Bankruptcy Code Exemptions[11], leaving debtors to seek exemption protection under applicable state law. The majority of cases interpreting state exemption schemes have found that inherited IRA are not protected[12].

2. PRE-PETITION TRANSFERS

Statement of Financial Affairs Question 18 requires all debtors to disclose all transfers occurring within two years of date of case commencement, other than in the ordinary course of business or financial affairs. This two year time frame is coincident with the two year time frame in Section 548 of the Bankruptcy Code, which is the fraudulent conveyance claw back provision. Pursuant to Section 544 of the Bankruptcy Code, Bankruptcy Trustees have access to longer claw back periods, most often four years, under applicable state law fraudulent conveyance statutes. Moreover, if the Internal Revenue Service is a creditor of the debtor, the applicable claw back period may be extended even further up to ten years[13]!

Many unpleasant provisions[14] of the Bankruptcy Code are implicated in cases where the debtor has transferred assets prior to filing (a) for less than reasonably equivalent value and at a time of insolvency, or (b) with intent to hinder, delay or defraud creditors. The combined effect of these provisions on the debtor and non-debtor third parties can be so detrimental that a bankruptcy filing may have to be delayed or possibly avoided entirely. Counsel should also

[10] See Lassman v. McGuire, 209 B.R. 580 (Bankr. D. MA. 1997)
[11] See Clark v. Rameker, 134 S. Ct. 2242 (2014)
[12] See In re Smith, 2018 Bankr. LEXIS 132 (Bankr. C.D. Ill. 2018I
[13] See Hillen v. City of Many Trees, LLV, (In re CVAH, LLC) 570 B.R. 816 (Bankr. D. ID. 2017)
[14] See Bankruptcy Code Sections 522(o), (p) and (q), 548, 727, 1141 and 1328.

consider whether corrective action may be taken to mitigate the adverse impact of pre-petition transfers, prevent harm to non-debtor third parties, and preserve the debtor's access to applicable exemptions and ability to obtain a discharge.

Impact of transfer reversal on the debtor's discharge – Counsel must explore the possibility of reversing a problematic transfer[15] prior to filing bankruptcy in an effort to preserve the debtor's ability to obtain a discharge. Bankruptcy Section 727 provides for discharge denial if a transfer is made with intent to hinder, delay or defraud a creditor and the transfer occurs within one year of case commencement. If the transfer is reversed, the bankruptcy filing date should be delayed for no less than one year and one day from the date that the original transfer occurred. Out of an abundance of caution, counsel should consider delaying the filing even longer, to a date that is at least one year and one day from the date that the transfer reversal is effective as a matter of state law (i.e. in the case of real estate, typically the date that the deed reversing the transfer is recorded) so that all relevant transfers relating to the asset in question are outside the one year look back period in Section 727. Debtors filing in the Ninth Circuit may not have to delay the filing at all after the transfer is reversed based on that Court's ruling in In re Adeeb, where the court allowed the granting of a discharge petition over a creditor's objections because the debtor disclosed the previous transfers to the creditors and was making a good-faith effort to recover the property at the time an involuntary bankruptcy petition was filed. In re Adeeb, 787 F.2d 1339 (9th Cir, 1986); c.f. Martin v Bajar (In re Bajar) 104 F.3d 495 (1st Cir. 1997) (discharge denied where debtor re-conveyed property post-petition).

[15] Reversal of a transaction may not be practical for many reasons apart from bankruptcy considerations. For instance, reversal may have adverse tax consequences, or reversal may require the cooperation of non-debtor third parties that are unable or unwilling to do so. For purposes of this article, it is assumed that there are no non-bankruptcy law impediments to reversing a transfer.

Impact of transfer reversal on the debtor's exemptions – Reversing a transfer prior to filing benefits a debtor because it allows the debtor to claim an exemption in the property being conveyed back to the debtor. Absent re-conveyance, a Trustee would have to exercise one of the strong arm powers to set aside the transfer and recover the property for the benefit of the bankruptcy estate. Pursuant to Section 522(g) of the Bankruptcy Code, a debtor loses the opportunity to claim an exemption in property that the Trustee recovers in the exercise of its strong arm powers if the debtor made the transfer voluntarily.

Transfer reversal may have adverse consequences on the amount of a debtor's homestead exemption in cases where the debtor is using the exemptions available under state law. Bankruptcy Code Section 522(p) places a cap of $160,375.00 on the amount of the homestead exemption available under state or local law if the debtor's interest in the property is acquired within 1215 days of the petition date. A debtor will acquire its' interest in property when the transfer is reversed. Therefore, the debtor's homestead exemption will be capped unless the bankruptcy filing is postponed for 1215 days from the date that the transfer is reversed, an option that is probably not viable for debtors already under severe financial pressure. This problem is particularly acute in states with homestead exemptions in excess of the bankruptcy code cap.

3. CONCLUSION

Identify complex assets and pre-petition transfers and implement pre-filing strategies to minimize harmful consequences and preserve the debtor's opportunity to preserve exemptions and obtain a discharge

Pre-Bankruptcy Planning

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Pre-Petition "Improvements"-- What can you do pre-filing to enhance your client's "fresh start" without making it a "head start?" The key to pre-bankruptcy planning is fully understanding a client's situation. Counsel cannot address or advise as to a situation that they do not know about. Debtor's counsel should have routine practices in place to uncover assets that the Debtor may not know they have. Ask the questions you know the trustee will ask and ask them multiple times, in multiples ways, using terms your client will understand. Explain why you are asking. Relying on an already stressed client to complete a questionnaire is not sufficient. Often times a Debtor does not realize that he has an asset. Frequently thorough due diligence will lead to the discovery of assets or issues that need to be addressed pre-petition in order for the Debtor to have a painless (or at least less painful) bankruptcy experience. Debtors tend to be more focused on the debt they need to discharge, rather than the assets that they need to protect. The attorney's job is to discover the asset and then work with the debtor to protect the asset.

1. **Transfer of Assets and Conversion of Non-Exempt Assets to Exempt**-- Typical schemes include (a) transfer to a friend or relative for little or no consideration, (b) conversion from non-exempt to exempt property, (c) encumbering the property, or (d) sale of the property. While there are certainly types of pre-petition asset planning that are permissible (discussed below), engaging in activities that exceed the bounds of the law prior to filing a Chapter 7 may have consequences for both the Debtor and potentially his/her attorney as well.

    a. **Potential Consequences to the Client for overly zealous pre-petition planning-** A Debtor who transfers or sells property may face a discharge action brought by the U.S. Trustee or the Chapter 7 Trustee pursuant to 11 U.S.C. §727(a)(2)(A). This provision states that a Debtor shall not be granted a discharge if with intent to hinder, delay, or defraud a creditor *or an officer of the estate charged with custody of property* he transfers, removes, or conceals property of the Debtor within 1 year before the date of filing of the petition. Note

that this provision does not have an exception for a transfer for reasonable or equivalent value. A literal reading would include *any* transfer, a potentially problematic provision indeed.

i. To avoid running afoul of this provision, clients should have and be able to articulate a valid reason for the transfer, such as to obtain money to live on until a case can be filed or perhaps to get caught up on things like property taxes, car payments, or mortgage arrears where otherwise a Chapter 13 may be required.

ii. A transfer or sale of property may also subject the transferee to potential liability to the Trustee under fraudulent transfer theories (or perhaps an 11 U.S.C. §547 preference theory if the transferee was a creditor at the time of the transfer). Title 11 provides that a transfer within 2 years of the filing date of the petition made either (a) with intent to hinder, delay, or defraud a creditor, or (b) for less than reasonably equivalent value when Debtor was either insolvent, in businesses with unreasonably small capital, intended to incur debts beyond the ability to repay, or made the transfer to an insider, may be avoided by the Trustee. 11 U.S.C. §548(a)(1).

1. Often this look back period may be extended by the Trustee by using state law.
2. Title 11 provides that a Trustee may avoid any transfer that is voidable under applicable law by a creditor holding an allowable unsecured claim. 11 U.S.C. §544(b)(1).

iii. To limit risk with respect to this provision, a client should document sales of property anticipated prior to bankruptcy, and if at all possible to have an independent valuation which matches the sales or transfer price in order to be able to provide that to the Chapter 7 Trustee to use in evaluating a potential avoidance action. An appraisal of some kind may not prevent the Trustee filing an avoidance action, but it will make it less likely and will enable a Debtor to satisfactorily explain the basis for the price obtained at the sale or transfer.

b. The conversion of non-exempt property to exempt property may result in a discharge objection under § 727 as discussed above. The reasoning for this is similar to that where property is sold or transferred. Where property is converted from non-exempt to exempt with the intent to hinder, delay, or defraud creditors, the potential for a discharge action under §727 exists. See *First Tex. Sav. Ass'n v. Reed (In re Reed)*, 700 F.2d 986 (5th Cir. Tex. 1983).

c. The conversion of non-exempt property to exempt property could also result in the potential sale of exempt property in order to recover the non-exempt converted portion. In consumer cases, this is most common in states where there is a generous homestead exemption. A Debtor may in some cases be tempted to use otherwise non-exempt property to reduce the balance of a mortgage secured by his homestead. Or, a Debtor may be tempted to encumber non-exempt property to make it less attractive to a Chapter 7 Trustee while then using those loan proceeds to reduce a mortgage balance. Typically mortgages are reaffirmed in Chapter 7, and so doing this is often in a Debtor's pecuniary interest. However,

11 U.S.C. §522(o) provides that the value of interest in a Debtor's residence able to exempted shall be reduced to the extent that the value is attributable to property the Debtor disposed of in the 10 year period prior to filing with intent to hinder, delay, or defraud a creditor and that was not exempt on the date the property was disposed of. The practical effect of this provision is that any money used to pay down a mortgage within the 10 year period prior to filing with intent to delay or defraud creditors can be recaptured by the Trustee. See *Cipolla v. Roberts (In re Cipolla)*, 476 Fed. Appx. 301 (5th Cir. Tex. 2012). It could be recaptured without sale of the homestead if a Debtor is fortunate enough to be able to repay it from post-petition earnings, or to borrow it from a relative or friend. Barring those two scenarios though, the Trustee can attempt to sell the property to recover the non-exempt § 522(o) portion of the equity in the property.

d. Proving actual intent to hinder, delay, or defraud creditors is not necessarily an easy task. It is a fact intensive (read time consuming and therefore potentially expensive) inquiry for the Trustee.
    i. That inquiry is very similar for purposes of both 727(a) and 522(o). *Cipolla*, 476 Fed. Appx. at 306. The inquiry includes one or more of the following factors, often referred to as badges of fraud:

(1) the lack or inadequacy of consideration;

(2) the family, friendship or close associate relationship between the parties;

(3) the retention of possession, benefit, or use of the property in question;

(4) the financial condition of the party sought to be charged both before and after the transaction in question;

(5) the existence or cumulative effect of the pattern or series of transactions or course of conduct after the incurring of debt, onset of financial difficulties, or pendency or threat of suits by creditors; and

(6) the general chronology of the events and transactions under inquiry.

(7) the transfer or obligation was concealed;

(8) before the transfer was made or obligation was incurred, the Debtor had been sued or threatened with suit;

(9) the transfer was of substantially all the Debtor's assets;

(10) the Debtor removed or concealed assets;

(11) the Debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred;

2. **Ethical Considerations--**Debtors frequently seek advice on ways to maximize the property they are able to preserve and still obtain a discharge. This situation can present an ethical problem for an attorney, who simultaneously has a duty of candor to the court as well as a duty to zealously represent a client within the confines of the law. What are the confines of the law? Is it ok to help a client take pro-active steps to protect assets from possible administration by a Chapter 7 Trustee anticipated to be appointed in an upcoming case? Are there potential consequences to the client who takes such advice? To the attorney?
    a. **Potential Consequences to the Attorney for Overly Aggressive impermissible**

pre-petition asset planning—

i. First, there is the potential loss of reputation or credibility. There is a good likelihood that a future case you file will be assigned to that same Trustee. The importance of maintaining credibility with Trustees cannot be understated. A Chapter 7 Trustee must make numerous decisions, and your input on behalf of your client often can help the Trustee make those decisions. If you have no credibility with the Trustee, then neither will your client. This is equally true with the U.S. Trustee in the event he or she becomes involved, not to mention with any disputes that make it before a bankruptcy judge. A lawyer only has one reputation to last during his or her entire career. There is not enough benefit in today's case to outweigh the potentially great cost to you and tomorrow's case if that reputation is harmed.

ii. Second, advising a client to incur or encumber debt as part of this pre-bankruptcy planning may run afoul of the §526 debt relief agency provision in Title 11, as attorneys are considered debt relief agencies by the statute. *Milavetz v. United States*, 130 S. Ct 1324, 1336 (2010). Attorneys are prohibited from advising clients to load up on debt with the expectation of obtaining a discharge.

1. Valid reasons to discuss incurring debt with a client about to file for bankruptcy do exist, particularly as outlined in footnote 6 of *Milavetz*.

a. Advice to refinance a mortgage or purchase a reliable car prior to filing because doing so will reduce the Debtor's interest rates or improve his ability to repay is not prohibited, as the promise of enhanced financial prospects, rather than the anticipated filing, is the impelling cause.

b. Advice to incur additional debt to buy groceries, pay medical bills, or make other purchases reasonably necessary for the support or maintenance of the Debtor or a dependent of the Debtor, is similarly permissible. *Id.* at 1339.

c. But §526(a)(4) does prevent giving advice principally motivated by the prospect of bankruptcy. *Id.* at 1338. The violation of this statute may result in an employment contract becoming void under § 526(c)(1), liability for actual damages and reasonable attorney's fees under §526(c)(2), or an action for an injunction under §526(c)(3)(A).

b. **Fee Disgorgement--** Near and dear to the hearts of consumer bankruptcy attorneys everywhere, there is the risk of disgorgement of fees. Title 11 provides that where compensation exceeds the reasonable value of services, the court may order the return of any such payment to the extent excessive to the estate. 11 U.S.C.§329. Reasonable value can be very elastic, particularly considering the

wide variety of factual contexts in which pre-bankruptcy asset protection schemes may be attempted. Nonetheless, attorneys should be aware of this provision.

c. **State Law-**Many states have laws regarding an attorney's potential liability for assisting a debtor in the transfer of assets to place the assets beyond the reach of creditors. It is important for a practitioner to know the law on this area in the state(s) where they practice, in addition to the relevant bankruptcy laws.

3. Can anything be done to Protect Potentially Non-Exempt Assets? Yes!

a. Generally, Debtors are entitled to maximize the protection of their assets prior to the filing of their bankruptcy case. *See Norwest Bank Nebraska, NA v. Tveten,* 848 F2d 871, 874 (8th Cir 1988) citing *Ford v. Poston*, 773 F2d 52, 55 (4th Cir. 1985) ("absent extrinsic evidence of fraud, mere conversion of non-exempt property to exempt property is not fraudulent as to creditors even if the motivation behind the conversion to to place those assets beyond the reach of creditors"); *In re Hurt,* 542 B.R. 798 (2015)(whether or not a transfer is fraudulent is fact intensive and requires examination of "badges of fraud" discussed *supra*).
   i. Know the law of your jurisdiction and look for the badges of fraud
   ii. In all instances, all transfers should be disclosed as required on the Statement of Financial Affairs.

b. Determine if the Debtor can hold off on filing and wait out the lookback periods in 11 U.S.C. §544, 547, 548, and 549.

c. Become very familiar with all exemptions. Often there are exemptions that are little known or rarely used that can be helpful.

d. Obtain third party valuations prior to filing. Frequently assets are less valuable than a Debtor believes.

e. Sell assets for fair market value and use the funds to live on prior to filing.

f. Keep exempt funds (such as social security) segregated

g. Spend Down Non-Exempt Funds
   i. Pay mortgage and/or homeowners association arrears or past-due rent
   ii. Do desired home improvements, including replacing aged appliances
   iii. Fund IRAs
   iv. Repay 401(k) loans
   v. Make estimated tax payments, if taxes are underwithheld
   vi. Get needed medical or dental treatment
   vii. Refill prescriptions
   viii. Car repairs/New tires
   ix. Stock pantry & freezer
   x. Pay delinquent child support

h. Tax Refunds—if possible, wait to file until refund has been received and spent on acceptable expenditures

i. Don't forget about 11 U.S.C. §541(a)(5) assets—explore whether the Debtor may become entitled to an inheritance within 180 days post-petition and recommend the use of a spendthrift trust prior to the assets ever becoming the Debtor's property.

4. Income Adjustments—Timing is everything! If a Debtor's income is over-median and, therefore, requires a Chapter 13 as opposed to a Chapter 7 below are some

considerations that may help reduce the Debtor's disposable income:

a. Was there a spike in income that may fall off the 6-month average?
b. Should a case be filed quickly if a bonus was just received so that the bonus is not counted in the 6-month average?
c. Should the Debtor accelerate or delay a divorce or separation?
d. Is the Debtor married? Is the Debtor's spouse not filing bankruptcy? If there is a non-filing spouse, the Debtor may be able to exclude portions of the non-filing spouse's income.
e. Should the Debtor be repaying a 401(k) loan or making retirement contributions? Part 2, line 41 of Form 122C-2 allows a Debtor to deduct these payments in Chapter 13. *See Gorman v. Cantu*, 713 F. App'x 200 (4th Cir. 2017)
f. Legitimately Maximize Other Necessary Expenses
    i. Debtors often minimize their necessary expenses when confronted with mounting debt.
    ii. 11 U.S.C §707(b)(2)(A)(ii) allows inclusion of "Other Necessary Expenses."
        1. This can include assistance to elderly, chronically ill or disabled household or immediate family members.
        2. It can also include new or increased health insurance, disability insurance or health savings account contributions.
    iii. The Religious Liberty and Charitable Donation Protection Act of 1998 ("the RLCDPA") amended Bankruptcy Code to provide that charitable contributions to a qualified religious or charitable entity up to 15% of the gross income of the debtor is an allowed deduction for the Means Test. Trustees will be wary of a debtor that "Finds Jesus at the Courthouse Door" and may seek proof that the contributions persist during the bankruptcy. *See, In re Gamble*, No. 11-80131, 2011 Bankr. LEXIS 2757 (Bankr. M.D.N.C. June 14, 2011).

Chapter Selection—There is much more to pre-bankruptcy planning than focusing on ways to preserve or exempt assets. Determining what Chapter of bankruptcy is best suited to a client's needs is one of the most important pre-bankruptcy planning devices. As with all pre-bankruptcy planning, determining the appropriate Chapter requires a thorough review of a client's financial situation, including a detailed review of income, expenses, and obligations. While Chapter 7 is often seen as preferable to a potential client there are frequently reasons that a Chapter 11, 12, or 13 may be a better option. Below is a non-exclusive list of considerations in determining the Chapter to best suit the client's needs:

1. Arrearage on secured debts cannot be cured in a Chapter 7. If the debtors are behind on mortgage or auto payments and want to keep the collateral, Chapter 11, 12, or 13 may be the best option.
2. If a Debtor is clearly over median and will be forced to file Chapter 13 due to income, the amount that will be distributed to unsecured creditors may cover the potential liquidation analysis without the need to spend down or transfer any assets.
3. Chapter 13 offers a broader discharge than Chapter 7

a. willful and malicious injury by the debtor to another entity or to the property of another entity [11 USC § 523(a)(6)]
b. civil fines and penalties [11 USC § 523(a)(7)]
c. debts that couldn't be discharged in a previous bankruptcy [11 USC § 523(a)(10)]
d. debts incurred to pay a nondischargeable tax debt [11 USC § 523(a)(14) and (14a)]
e. marital debts created in a divorce or settlement agreement [11 USC § 523(a)(15)]
f. condominium, cooperative, and homeowners' association fees incurred after the bankruptcy filing date [11 USC § 523(a)(16)], and
g. debts for loans from a retirement plan [11 USC § 523(a)(18)]

4. Chapter 11, 12, and 13 offer a Debtor the ability to protect and control all assets.