South Carolina Law Review

Volume 48 | Issue 4 Article 2

Summer 1997

Exemption Planning: How Far May You Go?

William J. Cassidy
United States Bankruptcy Court for the Southern District of Florida

A. J. Cristol
United States Bankruptcy Court for the Southern District of Florida

Alexandra S. Walden
United States Bankruptcy Court for the Southern District of Florida

SOUTH CAROLINA LAW REVIEW

VOLUME 48 SUMMER 1997 NUMBER 4

EXEMPTION PLANNING: HOW FAR MAY YOU GO?

*The Honorable A. Jay Cristol**

*William J. Cassidy***

*Alexandra Sarmiento Walden****

* A. Jay Cristol is Chief Bankruptcy Judge of the United States Bankruptcy Court for the Southern District of Florida and an Adjunct Professor of Law at the University of Miami School of Law.

** William J. Cassidy is a law clerk to the Honorable A. Jay Cristol. B.S., George Mason University, 1988; J.D., The University of Miami School of Law, 1992.

*** Alexandra Sarmiento Walden is a law clerk to the Honorable A. Jay Cristol. B.A., Florida State University, 1986; J.D., The American University, Washington College of Law, 1989.

I. INTRODUCTION

Under the Bankruptcy Act of 1898, a substantial body of case law developed which supported the proposition that conversion of non-exempt property into exempt property is not fraudulent per se and does not automatically defeat a debtor's claim of exemption.[1] The Bankruptcy Code of 1978 addresses the broad topic of exemptions in 11 U.S.C. § 522;[2] however, there is nothing in § 522 that deals specifically with the conversion of non-exempt property into exempt property. Congress attempted to provide some guidance on the extent and propriety of pre-bankruptcy planning, but the guidance finally issued is very sparse and leaves the road unmarked for wary travelers. The courts have done little more to mark the way.

Understandably, any bankruptcy petitioner would want to exempt and, thereby, keep as much property as the law allows for a fresh start. Evidencing empathy for the petitioner's desire, both the House and Senate Reports that accompanied the Bankruptcy Reform Act of 1978 provide that "under current law, the debtor will be permitted to convert non-exempt property into exempt property before the filing of a bankruptcy petition . . . . The practice is not fraudulent as to creditors and permits the debtor to make full use of the exemptions to which he is entitled under the law."[3]

Strangely enough, hearings referred to in both the House and Senate Reports arose as a result of a letter from Bankruptcy Judge Phelps and comments on the letter by committee members and witnesses condemning

1. *See* 1A COLLIER ON BANKRUPTCY ¶ 6.11[5] & n.29 (James Wm. Moore & Lawrence P. King eds., 14th ed. 1976).

2. 11 U.S.C. § 522 (1994).

3. S. REP. NO. 95-989, at 76 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5862; H.R. REP. NO. 95-595, at 361 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6317 (citation omitted).

bankruptcy planning.[4] Judge Phelps argued then what is still true today, that the case law on bankruptcy planning is in a state of utter confusion. Judge Phelps concluded that a debtor's making regular monthly mortgage payments on a homestead or other such payments "in the usual manner of living of the bankrupt"[5] is perfectly appropriate. He felt, however, that "the deliberate enlargement of exemptions out of the usual and customary manner of living and in contemplation of bankruptcy"[6] was "cheating"[7] which "shocks one's conscience"[8] and "brings the whole bankruptcy process into disrepute."[9] Judge Phelps' thoughts on the matter have been recorded in case law:

> "To have the bankrupt form the decision that he will file . . . bankruptcy proceedings and thereafter, with guidance from his attorney, to convert his salable assets into cash and then use that cash in such a way to hide it from his creditors, even while his attorney is typing up the schedules, appears to me to be fraudulent." Judge Phelps used the word "hide" to mean "shelter," not "conceal;" for he offered an example illustrated by a debtor's own statement of affairs. Former Bankruptcy Judge Cyr, now Judge of the First Circuit Court of Appeals, agreed that such conduct by debtors is "outrageous" and especially will be more prevalent as exemptions become more generous.[10]

Judge Phelps also concluded that "advice of counsel is no excuse for such conduct, but rather may be considered part of the essence of the offensive conduct."[11]

Thus, the plain language of the Senate and House Reports may be a less than accurate statement of Congressional intent on this issue. Indeed, Judge Alexander Paskay, Chief Judge of the United States Bankruptcy Court for the Middle District of Florida and author of the above passage, believes that Judge Phelps' broader view is "in accord with the language of the [Bankruptcy] Code and with the general principles of equity."[12]

The Congressional scheme of allowing disparate exemptions at the whim of the individual states simply adds to the confusion. In states with minimal allowed exemptions, ignoring the unlawful *implications* of pre-bankruptcy

4. *See In re* Schwarb, 150 B.R. 470, 471 (Bankr. M.D. Fla. 1992).

5. *Id.* "Bankrupt" was a pre-code term replaced by "debtor" in the 1978 Bankruptcy Code.

6. *Id.*

7. *Id.*

8. *Id.*

9. *Id.*

10. *Id.* at 471-72.

11. *Id.* at 472.

12. *Id.*; *see also In re* Spoor-Weston, Inc., 139 B.R. 1009, 1012 (Bankr. N.D. Okla. 1992) (discussing the idea that bankruptcy courts are to achieve equity in their decisions).

planning[13] and allowing a debtor to move non-exempt property to exempt status on the eve of petition would still leave debtors with inadequate resources for a fresh start and near the threshold of joining the ranks of the homeless. In other more generous, debtor-friendly states, the exemptions allowed are so grand that a song has been sung, "the debtor here [does] not want a mere *fresh* start, he wants a *head* start."[14]

II. CONFUSION SURROUNDING A QUANTITATIVE RULE

Should the quantity of exemptions claimed be a factor that courts consider in marking the pre-bankruptcy planning roadway? Some think that a quantitative standard is absolutely the rule. That is, there is an expanse of precedent asserting that being a little piggy with exemptions is O.K., but hogs get slaughtered.[15]

A. Doctors in Minnesota

Two learned and qualified bankruptcy judges, in separate cases, examined the activities of debtors Robert J. Johnson[16] and Omar A. Tveten.[17] Both debtors were medical doctors who dabbled in the same real estate investments, and each was indebted in the amount of approximately nineteen million dollars.[18] Each doctor sought the advice of counsel and openly converted nonexempt assets to exempt assets. Dr. Johnson sheltered approximately $340,000.00,[19] and Bankruptcy Judge Gregory F. Kishel ruled that to be

---

13. According to the Public Information Series of the Bankruptcy Judges Division, published by the Administrative Office of the United States Courts, pre-bankruptcy planning is defined as "[t]he arrangement (or rearrangement) of a debtor's property to allow the debtor to take maximum advantage of exemptions. (Pre-bankruptcy planning typically includes converting nonexempt assets into exempt assets.)" BANKRUPTCY JUDGES DIV., ADMIN. OFFICE OF THE U.S. COURTS, BANKRUPTCY TERMINOLOGY 3 (June 1995).

14. Albuquerque Nat'l Bank v. Zouhar, (*In re* Zouhar), 10 B.R. 154, 156 (Bankr. D.N.M. 1981).

15. *Id.* at 157; *see also In re* Englander, 156 B.R. 862, 871 (Bankr. M.D. Fla. 1992) (granting debtors leave to file an amendment to their improperly claimed homestead exemption, phrased as a "choice of being pigs or hogs").

16. Panuska v. Johnson (*In re* Johnson), 80 B.R. 953 (Bankr. D. Minn. 1987), *aff'd*, 101 B.R. 997 (D. Minn. 1988), *remanded by* 880 F.2d 78, 84 (8th Cir. 1989). The final disposition of Dr. Johnson's case appears in *Panuska v. Johnson (In re Johnson)*, 124 B.R. 290 (Bankr. D. Minn. 1991).

17. Norwest Bank Neb., N.A. v. Tveten (*In re* Tveten), 70 B.R. 529 (Bankr. D. Minn. 1987), *certifying questions to* 402 N.W.2d 551 (Minn. 1987), *aff'd*, 82 B.R. 95 (D. Minn. 1987), *aff'd*, 848 F.2d 871 (8th Cir. 1988).

18. Dr. Johnson was indebted in the amount of $19,000,000.00, *Johnson*, 80 B.R. at 954, and Dr. Tveten owed slightly less, $18,920,000.00, *Tveten*, 70 B.R. at 531.

19. *Johnson*, 80 B.R. at 955-56.

acceptable.[20] Dr. Tveten sheltered $700,000.00,[21] and Bankruptcy Judge Robert J. Kressel thought that was too much. Judge Kressel concluded that if the matter had been brought as a Chapter 7 case, discharge would be denied under 11 U.S.C. § 727(a).[22] What does this tell us? Is $700,000.00 too much, but less than $350,000.00 is acceptable?

Unfortunately, it is not that simple. Both cases went through the full appellate cycle to the United States Court of Appeals for the Eighth Circuit. The $700,000.00 case, although an interlocutory order, was affirmed all the way.[23] The $340,000.00 case was affirmed on appeal by the district court but then remanded by the court of appeals.[24] In particular, the Eighth Circuit allowed Dr. Johnson's exemption regarding his homestead but directed that the case be remanded "to the bankruptcy court for a fresh determination of the ultimate question of fraud."[25] The circuit court also commented that "[t]he amount of money involved in this exemption is irrelevant to a determination of whether, on all the facts, Johnson intended to defraud his creditors."[26] The exempt property, in addition to Johnson's homestead, consisted of annuities, life insurance, a harpsichord and a baby grand piano.[27]

In its original decision, the bankruptcy court found that Dr. Johnson had converted almost all of his non-exempt property, including interests in a business, stock, boats, a boat slip, furniture, antiques, pictures, cameras, tools and a car into cash which he then used to pay the mortgages on his homestead, as well as purchase annuities, life insurance and musical instruments (which were exempt in Minnesota).[28] Johnson was candid with the court regarding his motivation to convert assets into exempt forms. He stated that he wanted to fully avail himself of the exemptions that his lawyer told him were available. The court found that while the debtor never volunteered to his creditors that he was engaged in the wholesale conversion of his non-exempt assets into exempt assets, neither did he conceal his actions or fraudulently misrepresent his activities.[29] The bankruptcy court held that the debtor's intent to convert non-exempt property into property that was exempt under state law, was not sufficient to constitute fraud despite the large amount of

20. *Id.* at 963-64.
21. *Tveten*, 70 B.R. at 534.
22. *Id.* at 535.
23. See *supra* note 17 for *Tveten*'s full case history.
24. See *supra* note 16 for *Johnson*'s full case history.
25. *Johnson*, 880 F.2d at 84.
26. *Id.*
27. *Johnson*, 80 B.R. at 955-56.
28. *Id.*
29. *Id.* at 958-59.

money involved. As a matter of law, further conduct such as concealing his actions, was required to prevent Johnson's discharge.[30]

As mentioned above, the district court affirmed this decision.[31] The Eighth Circuit, however, saw things differently. Where the bankruptcy court initially saw only "Dr. Johnson's conscious, if selfish, effort to fully avail himself of the full range of debtor protections afforded by the Minnesota state legislature, in a fashion which had been explicitly condoned by decisions of both state and federal courts in Minnesota,"[32] the Eighth Circuit saw Johnson possibly engaging in fraud in light of the "value-limit analysis of *Tveten*."[33] The circuit court stated its reasoning as follows:

> *Tveten* establishes that where an exemption, other than a homestead exemption, is not limited in amount, the amount of property converted into exempt forms and the form taken may be considered in determining whether fraudulent intent exists.
>
> . . . .
>
> We hold that *Tveten* does not apply to homestead exemptions absent traditional extrinsic evidence of fraud unrelated to the amount of money involved. In addition, we remind the lower courts that there is nothing fraudulent per se about making even significant use of other legal exemptions. Ultimately, fixed dollar limits on the use of exemptions must be set by legislatures. *Tveten* and *Hanson* sanction an exceptional use of judicial discretion. In light of the danger that judges will inadvertently fix inconsistent or arbitrary limits on the statutory exemptions, we must err in favor of the debtor. The power sanctioned in *Tveten* should be reserved for exceptional cases and has no application to homestead exemptions.[34]

The Eighth Circuit remand was a call to review the exemptions claimed for life insurance and the musical instruments and to make a fresh determination of whether fraudulent intent existed according to the standards announced in *Tveten*. On remand, the bankruptcy court found fraudulent intent with respect to these two claimed exemptions and ordered that the debtor be denied discharge.[35] Apparently using hindsight, the bankruptcy court noted that the life insurance policy which the debtor bought shortly before filing for

30. *Id.* at 959.

31. *See supra* text accompanying note 24.

32. *Johnson*, 80 B.R. at 963.

33. *Johnson*, 880 F.2d at 84.

34. *Id.* at 82, 83-84 (footnote omitted).

35. *Johnson*, 124 B.R. at 297. The bankruptcy court observed that given the relatively modest sums represented by the two exemptions which caused the debtor to lose his discharge, it seemed "that the kingdom was lost for a farthing in this case." *Id.*

bankruptcy was cashed in shortly after filing and the money spent.[36] The court also noted that during the trial, the debtor had admitted that neither he nor his girlfriend could play the musical instruments and that they were sitting in storage in debtor's basement.[37] Judge Kishel's exact statement denying discharge is worth noting:

> The evidence is clear, unequivocal, and conclusive: Debtor intended to use his claims of exemption in the keyboard instruments and the [life insurance] policy as a temporary "shelter" for the several thousands of dollars' worth of value involved. The corollary finding—that he fully intended to recoup that value by liquidating the exempt forms after financial pressures abated—is established as accomplished fact in the case of the [life insurance] policy, and as the only reasonable inference in the case of the keyboard instruments. The clear dictate of *Tveten* and *Johnson* is that intent of this sort equates to the intent which merits denial of discharge under 11 U.S.C. § 727(a)(2)(A).[38]

Meanwhile, Dr. Tveten, who still had the $700,000.00 which he had sheltered, continued to wander through Chapter 11. A hearing was held before Judge Kressel on the issue of whether or not that which could not be discharged in Chapter 7 under 11 U.S.C. § 727(a) could be discharged under 11 U.S.C. § 1141(d)(3) by confirmation of a Chapter 11 plan.[39] Judge Kressel answered this question in the affirmative.[40] Dr. Tveten's strategy succeeded! Thus, the initial postulate—that the little pig is O.K., but the hog gets slaughtered—may be false, at least so far as Minnesota doctors are concerned.

B. Farmers in South Dakota

Farmer Hanson and his wife, Lucille, residents of South Dakota, also in the Eighth Circuit, filed a joint voluntary petition under Chapter 7 of the Bankruptcy Code.[41] Prior to the filing and on the advice of counsel, they sold certain non-exempt property to their son, including a car, two vans, and a motor home. They also sold their household goods and furnishings to farmer Hanson's brother; however, the Hansons apparently retained possession of all the assets they sold. Farmer Hanson purchased approximately $20,000.00 in

36. *Id.* at 293-94.

37. *Id.* at 294-95.

38. *Id.* at 297.

39. Norwest Bank Neb., N.A. v. Tveten (*In re* Tveten) 97 B.R. 541 (Bankr. D. Minn. 1989).

40. *Id* at 542.

41. Hanson v. First Nat'l Bank, 848 F.2d 866, 867 (8th Cir. 1988).

insurance and then, a few weeks later, paid $11,000.00 against the mortgage on his homestead. Two days after paying down the homestead mortgage, Farmer Hanson filed his voluntary petition.[42]

Under South Dakota law, a debtor may exempt up to $20,000.00 as well as a homestead.[43] The bankruptcy court rejected a challenge to these exemptions. The bankruptcy and district courts found that the Hansons had done what was permissible under the law and that their actions did not constitute extrinsic evidence of fraud.[44] Eventually, the Court of Appeals for the Eighth Circuit gave its blessing: "The sole issue on appeal is whether the Hansons should not be allowed to claim their life insurance and homestead exemption as a product of fraudulent conveyances. We affirm."[45] On the issue of solvency, the Eighth Circuit added additional guidance, stating that "[t]he debtor's mere conversion of non-exempt property to exempt property, even while insolvent, is not evidence of fraudulent intent as to creditors."[46]

C. Doctors and Farmers Contrasted

Judge Arnold saw fit to write a concurring opinion in *Hanson* in which he compared the cases of Farmer Hanson and Doctor Tveten:[47]

> So far as I can tell, there are only three differences between Dr. Tveten and the Hansons, and all of them are legally irrelevant: (1) Dr. Tveten is a physician, and the Hansons are farmers; (2) Dr. Tveten attempted to claim exempt status for about $700,000.00 worth of property, while the Hansons are claiming it for about $31,000.00 worth of property; and (3) the Minnesota exemption statute whose shelter Dr. Tveten sought had no dollar limit, while the South Dakota statute exempting the proceeds of life insurance policies is limited to $20,000.00. The first of these three differences—the occupation of the parties—is plainly immaterial, and no one contends otherwise. The second—the amounts of money involved—is also irrelevant, in my view, because the relevant statute contains no dollar limit, and for judges to set one involves essentially a legislative decision not suitable for the judicial branch. The relevant statute for present purposes is 11 U.S.C. § 522(b)(2)(A), which authorizes debtors to claim exemptions available under "State or local law," and says nothing about any dollar limitations, by contrast to 11 U.S.C. § 522(d), the federal schedule of exemptions, which contains a number of dollar limitations. The third

42. *Id.*

43. *Id.*

44. *Id.* at 868.

45. *Id.*

46. *Id.* (emphasis added).

47. Judge Arnold was on both the *Tveten* panel and the *Hanson* panel; however, he did not sit on the *Johnson* panel.

> difference—that between the Minnesota and South Dakota statutes—is also legally immaterial, and for a closely related reason. The federal exemption statute, just referred to, simply incorporates states and local exemption laws without regard to whether those laws contain dollar limitations of their own.
>
> The Court attempts to reconcile the results in the two cases by characterizing the question presented as one of fact—whether the conversion was undertaken with fraudulent intent, or with any intent to delay or hinder creditors. In *Tveten*, the Bankruptcy Court found fraudulent intent, whereas in *Hanson* it did not. Neither finding is clearly erroneous, the Court says, so both judgments are affirmed. This analysis collapses upon examination. For in *Tveten* the major indicium of fraudulent intent relied on by the Bankruptcy Court was Dr. Tveten's avowed purpose to place the assets in question out of the reach of his creditors, a purpose that, as a matter of law, cannot amount to fraudulent intent, as the Court's opinion in *Hanson* explicitly states. The result, in practice, appears to be this: a debtor will be allowed to convert property into exempt form, or not, depending on findings of fact made in the court of first instance, the Bankruptcy Court, and these findings will turn on whether the Bankruptcy Court regards the amount of money involved as too much. With all deference, that is not a rule of law. It is simply a license to make distinctions among debtors based on subjective considerations that will vary more widely than the length of the chancellor's foot.[48]

Judge Arnold, it seems, has reinstated the Piggy Rule with enough latitude to include Dr. Tveten's $700,000.00.

D. Farmers Revisited: The Nebraska Perspective

Even farmers, however, can run afoul of the Piggy Rule. Chief Judge Timothy J. Mahoney of Nebraska found extrinsic evidence of fraudulent intent in the actions of a farmer Armstrong and his son.[49] Specifically, the farmer and his son embarked on a series of transactions that, taken together, had the effect of protecting farmer Armstrong from liability; giving his son and daughter-in-law cash to invest in exempt property; selling or encumbering much of the son's property; and improving one creditor bank's position at the expense of another creditor bank.[50] When Judge Mahoney saw such sums as $79,000.00, $600,000.00 and $228,000.00 flying around, there was no room

48. *Hanson*, 848 F.2d at 870-71 (emphasis added) (citations omitted).

49. Armstrong v. Bank of Hemingford (*In re* Armstrong), 931 F.2d 1233, 1239 (8th Cir. 1991).

50. *Id.* at 1235.

for a little piggy to fly as well.[51] Since his ruling was not clearly erroneous, he was affirmed all the way to the Eighth Circuit.[52]

E. A Commoner's Travail: Florida's View of the Piggy Rule

Let us take a look at a Florida case. Not a famous Florida case like former baseball commissioner Bowie Kuhn's,[53] which tells of a rich New York lawyer who was able to move to Florida and shelter a million dollar home on the picturesque St. Johns River, or that of a convicted felon like Marvin Leon Warner,[54] who claimed a homestead exemption on his $3.5 million dollar horse ranch in Ocala. No, let us look at a Florida case involving plain poor folks.

Leslie Barker and his wife, Elnora, were both over seventy years of age.[55] They both received a monthly Social Security check. Most of Mrs. Barker's Social Security proceeds were used to purchase necessary medications. Mr. Barker supplemented his monthly Social Security income by operating a part-time clock repair business from his home. The record is not clear on the point, but we can assume that the Barkers had a vicious habit, probably eating, which was supported by Mr. Barker's income. Certainly, the Barker's vices did not include home ownership. As the record discloses, the Barkers were unable to make the monthly payments on their mobile home, and they had voluntarily allowed Sun Bank to repossess the home a year prior to their bankruptcy filing. After taking possession, Sun Bank sued the Barkers for a deficiency judgment. The Barkers eventually sought the advice of a bankruptcy lawyer. Following this advice, the Barkers sold their last assets which consisted of some stock in a Merrill Lynch account. The sale netted the Barkers approximately $15,042.34. The Barkers invested $14,007.00 in an annuity, and five days later, they filed bankruptcy. Apparently, their only debt was the deficiency claim of Sun Bank.[56]

The Barker's trustee objected to the annuity investment because, as he saw it, the Barkers had "transferred the funds into an annuity with the intent to

51. *Id.* at 1235-36.

52. *Id.* at 1238.

53. Bowie Kuhn was a former commissioner of baseball who became a partner in the Kuhn & Myerson law firm of New York. Following the bankruptcy of Kuhn & Myerson, he immigrated to Jacksonville, Florida, where he filed bankruptcy to shed the liability of the personal guarantees he had signed at Kuhn & Myerson. He lives in a one million dollar home at Marshland Country Club. *See Bankrupt? In Debt? Move to Florida*, N.Y. TIMES, July 25, 1993, at 1.

54. *In re* Warner, 90 B.R. 532 (Bankr. M.D. Fla. 1988).

55. Crews v. First Colony Life Ins. Co. (*In re* Barker), 168 B.R. 773, 774-75 (Bankr. M.D. Fla. 1994).

56. *Id.* at 775.

hinder, delay, or defraud a creditor or an officer of the estate."[57] Judge Funk, in his wisdom, overruled the trustee's objection to the exemption. He then granted the Trustee's request to avoid a fraudulent transfer, and finally, he denied Mr. Barker's discharge for hindering, delaying and defrauding creditors.[58] Perhaps Judge Funk weighed most heavily Mr. Barker's candid admission that the transfer of the stock proceeds into an annuity was a "desperate attempt to save the last of [the Barkers'] savings."[59]

It is difficult to reconcile the *Barker* case with the *Tveten* decision in which, on the advice of counsel, Dr. Tveten made the pre-petition transfer, disclosed it, and ended up keeping $700,000.00, even though the Eighth Circuit felt the doctor's discharge should have been denied in a Chapter 7 case.[60] It is likewise difficult to reconcile the Barker's dilemma with that of farmer Hanson,[61] who purchased his annuities a few weeks before the filing and paid down his homestead mortgage two days before filing. For what appears to be the same conduct and with a larger sum being sheltered ($31,000.00 compared to the Barker's $14,007.00), the Eighth Circuit determined that farmer Hanson had done what was allowed by law.[62]

It appears that courts in the Eighth Circuit distinguish between doctors and farmers (even though they say they do not). In the Eleventh Circuit, there seems to be a distinction between convicted felon securities manipulators or celebrity lawyers, and old age pensioners, with the old age pensioners getting the short end of the stick. But then again, why would septuagenarians need a fourteen-thousand-dollar ($14,000.00) annuity in their advanced age? They can live it up on their Social Security benefits, and when they die, Social Security will give them each $250.00 for burial expenses.

F. Tampa's Gulf-side Approach

Obviously, the Piggy Rule is not alive and well in Jacksonville, Florida. Perhaps it is better to live in Tampa, Florida where Chief Judge Paskay allowed Mr. and Mrs. Myron Levine to transfer $440,000.00 of non-exempt assets into annuities a few months before they filed bankruptcy and to retain their exemption.[63] More important, the judge ruled that the pre-petition

57. *Id.* at 780.

58. *Id.*

59. The actual question and answer testimony was as follows:

Q: "[The annuity] was for your retirement?"

A: "Yes. That's the only income we had besides social security."

Id. at 777.

60. Norwest Bank Neb., N.A. v. Tveten, 848 F.2d 871 (8th Cir. 1988)

61. Hanson v. First Nat'l Bank, 848 F.2d 866 (8th Cir. 1988).

62. *Id.*

63. Weissing v. Levine (*In re* Levine), 139 B.R. 551 (Bankr. M.D. Fla. 1992).

conversion of non-exempt assets did not involve a "transfer" and could not be challenged as a fraudulent transfer under either the Florida Statutes or the Bankruptcy Code.[64] In his opinion, Judge Paskay noted that by allowing the claimed exemptions, the court did not intend an "approval of such 'pre-bankruptcy planning'"[65] The judge even went so far as to explicitly state that the conversion of non-exempt assets into exempt assets in some cases might be "grounds to bar a debtor's discharge."[66] The caveat held true. Two years later, Chief Judge Paskay decided that Mr. Levine's pre-petition conversion of non-exempt assets into exempt assets was done with the intent to defraud a judgment creditor. Mr. Levine was finally denied his discharge.

G. The New York Alternative

How does the Piggy Rule fare in the "Big Apple"? In *Up State Federal Credit Union v. Carletta (In re Carletta)*,[67] Chief Judge Stephen Gerling applied the Piggy Rule, holding that the amount of non-exempt property converted to exempt assets is relevant to a Bankruptcy Code § 727(a) determination.[68]

Upon the advice of their bankruptcy counsel, the debtors, Nicholas and Larae Carletta, purchased universal life insurance policies two weeks prior to filing a voluntary bankruptcy petition. The debtors admittedly used non-exempt assets, consisting of cash and tax refunds in the combined amount of $7,562.00, to buy the insurance policies and to prevent the trustee from acquiring an interest in their non-exempt assets.[69] A creditor, Up State Federal Credit Union, filed an adversary proceeding, alleging that the debtors had converted their non-exempt assets with the intent to hinder, delay and defraud creditors.[70] Up State relied primarily on the Eighth Circuit's *Tveten* decision but also put forward an interesting policy argument. The plaintiffs urged that "allowing Debtors to transfer all of their non-exempt property into a vehicle which enjoys an unlimited exemption under state law will result in the extinction of the Chapter 7 'asset' case."[71]

64. *Id.* at 552. This is directly opposite to Judge Funk's decision in *Barker*. It is, however, apparently the clear majority view.

65. *Id.* at 554.

66. *Id.*

67. 189 B.R. 258 (Bankr. N.D.N.Y. 1995).

68. *Id.* at 263.

69. *Id.* at 260. The trustee filed an objection (pursuant to 11 U.S.C. § 522(l)) to the debtors' claimed exemption in the insurance policies; however, he withdrew his objection in reliance upon the court's decision in *In re Moore*, 177 B.R. 437 (Bankr. N.D.N.Y. 1994). *Carletta*, 189 B.R. at 260.

70. *Id.*

71. *Id.* at 260-61.

Declining to follow *Tveten*, Judge Gerling held that the debtors' conduct did not demonstrate an intent to hinder, delay or defraud a creditor:

> While unwilling to judicially create dollar limits on exemptions, the Court finds that the amount of non-exempt property converted to exempt assets is relevant to a Code § 727(a) determination. In addition, such factors as debtor's awareness of the judgments against him and the pending suits, coupled with his failing investments, extensive personal liability and incapacity to pay helped develop a portrait of the debtor in *Tveten* which is vastly different from that presented . . . of Nicholas and Larae Carletta. . . .
>
> . . . .
>
> The Court is unpersuaded by Up State's policy argument. The holding of this case will not extinguish Chapter 7 "asset" cases because a determination of fraud is fact specific. . . . Thus, Up State's failure to present a compelling factual record does not doom all Chapter 7 "asset" cases.[72]

H. New Mexico Bacon

In New Mexico, the Piggy Rule is operating in full force. In the case of *In re Zouhar*,[73] Judge Robert A. Johnson ruled that self-induced insolvency is not protected under the New Mexico exemption statute.[74] After a long and rather acrimonious divorce, the debtor found himself in a somewhat "tight" situation; he was indebted in the amount of approximately $40,000.00, most of which was traceable to the divorce. The debtor, a successful anesthesiologist, decided that he did not want to see any of his money go to, or benefit, his former wife. Consequently, he consulted with his divorce attorney, who in turn referred him to bankruptcy counsel.[75]

Dr. Zouhar had a little problem—he had annual earnings of $70,000.00; a profit sharing trust, wholly exempt under state law, in the amount of approximately $85,000.00; and stock in his professional corporation, fairly valued at approximately $44,000.00. In order to avoid paying any sums to his former wife and trustee, the debtor engineered certain transactions that would convert non-exempt assets into exempt assets: he purchased a home; he prepaid his son's tuition in the amount of $1,860.00; he made payment in the amount of $400.00 on an account slightly in excess of $300.00; and, made a payment of $243.28 on a car owned by a friend.[76] His biggest transaction, however, involved the stock of his professional corporation. Two days prior to filing a bankruptcy petition, Dr. Zouhar borrowed $44,792.50, pledging the

72. *Id.* at 263.
73. Albuquerque Nat'l Bank v. Zouhar (*In re* Zouhar), 10 B.R. 154 (Bankr. D.N.M. 1981).
74. *Id.* at 158.
75. *Id.* at 155.
76. *Id.*

stock in his professional corporation as collateral, and purchased an annuity with the funds. The amount borrowed and subsequently invested in the annuity exceeded all of Dr. Zouhar's unsecured debts.[77] Neither the Albuquerque National Bank nor the former Mrs. Zouhar was amused. The bank, Dr. Zouhar's mortgage holder, took the lead role in objecting to the doctor's claim for discharge.[78]

Judge Johnson held the pre-bankruptcy conversion of non-exempt assets to exempt assets was fraudulent and denied the debtor's discharge. The judge noted that if the pre-bankruptcy payments and conversions had been deemed valid, Dr. Zouhar would have emerged from bankruptcy with a net worth of approximately $130,000.00.[79]

> "There is a principle of too much; phrased colloquially, when a pig becomes a hog it is slaughtered." That principle fully applies here. While 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 otherwise would go to creditors is not permissible.
>
> At least here, where the transmutation of assets was in an amount sufficient to render the debtor insolvent, and where the amount transmuted was more than sufficient to pay all of the debtor's unsecured debts, the transmutation must be stamped as fraudulent. . . .
>
> Moreover, the purpose which motivated Zouhar in this case is not the purpose for which the New Mexico legislature enacted the exemption statute. Zouhar forthrightly admitted that he had no interest in the annuity for any retirement or insurance purpose, and merely utilized this method as a device to shield his assets from his creditors.[80]

III. STEPPING BACK FOR A CLEAR VIEW OF EXEMPTION PLANNING

We could continue to move around the United States and point to further inconsistencies in both the understanding and application of the Piggy Rule. Certainly, however, the two most prominent features of such a survey have already been revealed. First, the state of the law and its application are not clear; and second, the Piggy Rule is probably not kosher.[81]

---

77. *Id.* at 156.

78. *Id.* at 154.

79. *Id.* at 156.

80. *Id.* at 157.

81. Alex Kozinski & Eugene Volokh, *Lawsuit, Shmawsuit*, 103 YALE L.J. 463 (1993). According to Kozinski and Volokh, "kosher" is not Yiddish Argot in American law but is rather an accepted American legal term. *Id.* at 465 (citing Texas Pig Stands, Inc. v. Hard Rock Cafe Int'l, Inc., 951 F.2d 684, 698 (5th Cir. 1992); United States v. Erwin, 902 F.2d 510, 513 (7th Cir. 1990)).

Rather than survey the entire roadway, however, a more practical course would be to consider some concepts which mark the boundary and which should not be crossed. But let the traveler beware. The points marked do not make a solid embankment; there are gaps which tend to move and shrink or widen. The boundary sometimes may curve outward giving more room to maneuver on the pre-bankruptcy planning road, or it may curve inward, making the road narrower.

This curving roadway and the vagaries of its judicial interpretation should be a concern for lawyers advising clients on the road to bankruptcy. Lawyers should question, with great trepidation, how far they may go in assisting a client with pre-bankruptcy planning without themselves becoming conspirators in fraud. On the other hand, the research supporting this article did not disclose a single case where an attorney was sanctioned along with a debtor for hindering, delaying or defrauding creditors.

The fundamental premise of American consumer bankruptcy law is the fresh start which, through the interplay of discharge and exemption, provides for a reasonable standard of living in exchange for the surrender of non-exempt assets at filing.[82] Moreover, both state and federal bankruptcy laws have generally recognized exemptions as necessary to preserve a debtor's access to property that is essential to life and livelihood.[83] The exemption is also viewed as a means of shifting the burden of support (for the debtor and the debtor's dependents) from the public to private credit sources.[84] According to Professor Alan Resnick, five distinct social policies are promoted by exemptions: (1) providing property needed for the debtor's physical survival; (2) protecting the debtor's dignity, culture and religious identity; (3) ensuring the financial rehabilitation of the debtor; (4) ensuring the debtor's family does not become impoverished; and (5) shifting the burden of providing for the debtor and family from society to the creditor.[85]

At any rate, setting an appropriate exemption ceiling is a legislative function not a judicial function. Congress should establish one standard rather than allow the 326 bankruptcy judges throughout the land to express their individual ideas about which little piggy goes to market and which little piggy stays home.

82. 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, 236-46 (1995).

83. *Id.*

84. 2 NORTON BANKRUPTCY LAW AND PRACTICE 2D § 46:1 at 46-3 (William L. Norton, Jr., ed., 2d ed. 1994).

85. 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, 621 (1978); *see also* Douglas E. Deutsch, Note, *Exemption Reform: Examining the Proposals*, 3 AM. BANKR. INST. L. REV. 207, 207-08 (1995).

IV. AN ATTORNEY'S PROPER (ETHICAL?) ROLE

The clear goal of pre-bankruptcy planning is to maximize the debtor's outcome in bankruptcy based upon the form in which assets are held at the time a voluntary petition is filed. Counsel's task is to advise the client of what the client may and may not do to preserve assets. Counsel 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 debtor's discharge (and disciplinary or criminal actions against the attorney). It is easy to say that counsel must always act in deference to the ethical responsibilities and standards governing members of the bar. The more difficult task is determining an allowable limit—how far can you go? The only absolute answer is that the attorney must remain an attorney and not become a participant. Granted, this does not answer much of the question. The attorney must conduct a reasonable investigation, establish the facts, and advise the client of all options and risks. It is wise to memorialize the representations made, facts established and the advice given in a letter bearing the counter-signature of the client. It is sad how memories fail when plans go awry.

A commercial airline pilot knows the aircraft's flight capabilities and operates far from the edge because, for the common carrier, safety is paramount. By contrast, a fighter pilot operates as close to the edge as possible without penetrating or going over it because, in the military, winning by getting the absolute most out of one's aircraft is the name of the game. A bankruptcy lawyer is more analogous to the fighter pilot. Taking the safe route and advising in the most cautious and conservative manner may leave a client to begin a fresh start with a pair of used jeans and a torn shirt. Zealous and ethical representation demands more. The attorney must go as far as possible without crossing the line.

The primary tenet of pre-bankruptcy planning is, or should be, "Thou shalt not commit fraud!" On one extreme is the debtor[86] who buys a million dollars worth of widgets on credit, sells the widgets for a million dollars, transfers the million dollars to an exempt asset and files a petition in bankruptcy court. By filing, this debtor seeks to keep the million dollar exempt asset and to pay his creditors nothing. It seems clear that such a scenario is a fraud on the creditor. Surely the creditor relied on the debtor to sell the widgets and pay over the proceeds after sale. Similarly, the debtor's actions are a fraud upon all other creditors who may have relied on the debtor's apparent assets.

86. Technically, prior to filing a petition, a person is not a debtor. He or she is but a potential or prospective debtor. For purposes of simplicity, the term "debtor" and "prospective debtor" are used interchangeably.

On the other extreme is the debtor who finds a winning lottery ticket and transfers the million dollar prize into an exempt asset. In this scenario, no creditor extended credit to the debtor in reliance on the lottery prize. It was the debtor who found the winning ticket, not the creditors. No one is defrauded, and no one justly relies on the debtor's yet-to-be-won prize when extending credit.

If the above two scenarios were the only two to occur, the rules and process of advising on the boundary of the road would be easy. Unfortunately, these examples are the approximate opposite ends of the spectrum, and there are an infinite number of degrees and shades in between. And the line you shall not cross? It is not that easy to determine.

V. WHAT DOES A DEBTOR TRULY NEED FOR A FRESH START?

Before discussing in detail what a debtor needs and what an attorney may supply, a glance at the structure of the law would be wise: In some states, a debtor may utilize the federal exemptions enumerated in § 522(d) of the Bankruptcy Code wherein Congress contemplated that approximately $50,900.00 is sufficient for a fresh start.[87] In states that have opted out of the federal exemptions standard pursuant to 11 U.S.C. § 522(b)(1),[88] a debtor may utilize any exemptions entitlement granted under state law and non-bankruptcy federal law.[89] The thirty-five states which have opted out of the federal exemptions scheme vary dramatically in their views of an appropriate fresh start. Some debtor-friendly states require as much as unlimited wealth. Debtor-averse states, such as Arkansas,[90] accept as little as an $800.00 personal property exemption.[91]

The question of what a debtor needs for a fresh start is a matter of legislative policy, not judicial decision. Present legislative guidelines, which again range from next-to-nothing to unlimited wealth, are no guidelines at all. If bankruptcy is to remain a federal matter,[92] the conflict must be resolved

---

87. This amount is the product of rough calculation. It is imminently subject to variation and argument as to exactness, but it is in the general ballpark.

88. The states which have opted out include Alabama, Arizona, Arkansas, California, Colorado, Delaware, Florida, Georgia, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Missouri, Montana, Nebraska, Nevada, New Hampshire, New York, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, South Carolina, South Dakota, Tennessee, Utah, Virginia, West Virginia, and Wyoming.

89. *See* 11 U.S.C. § 522(b) (1994); *see also, e.g.*, *In re* Planas, 199 B.R. 211, 214 (Bankr. S.D. Fla. 1996) (citing 11 U.S.C. § 522(b)); Dionne v. Harless (*In re* Harless), 187 B.R. 719 (Bankr. N.D. Ala. 1995) (citing 11 U.S.C. § 522(b)).

90. ARK. CODE ANN. § 16-66-218(a)(1) (Michie Supp. 1995).

91. The basic personal property exemption is an amount calculated for single individuals and often does not include exemptions for specific items of personalty such as jewelry or automobiles.

92. The Constitution seems to require that bankruptcy be treated as a federal matter.

between what is a fair fresh start for an honest debtor and the right of states to opt out and define their own various exemptions. The simplest and fairest solution would be to eliminate the opt-out provisions of the bankruptcy code and allow everyone the federal exemption. Unfortunately, in our political society, the simplest and fairest solution is not always *politically* feasible. A reasonable compromise would be to continue to allow states to opt-out but to limit any state's exemption scheme to a specific total dollar amount which could be set forth as a function of the federal exemption.[93] This would answer the objections of states which believe that a fresh start within their borders costs more than a fresh start in some other state. Another variation might be to put a cap on the maximum allowable exemptions.[94] Senator Kohl's attempt during the last Congress to cap excessive or unlimited homesteads was a step in the right direction, but his legislation, Senate Bill 769, does not address the issues of unlimited insurance, annuities and pension accounts. The concept of an unlimited exemption of any kind gives the entire bankruptcy system a bad image.

A. A Closer Look: Exemptions by Category

Exempt property can be divided into three categories; the sacred homestead, annuities insurance and pension funds, and other assets such as automobiles, tools of the trade or jewelry.

1. The Sacred Homestead

The degree of concern for keeping a roof over a debtor's head varies throughout the country. Some states do not include any exemption for a homestead, while others carry the homestead exemption to the absurd.[95]

The Florida Constitution confers a broad homestead exemption. Existing exceptions to the Florida exemption include only taxes and assessments; obligations incurred in connection with the purchase, improvement or repair of a homestead; obligations incurred in connection with labor performed at or on the real estate; a creditor's claim which is itself based on the claims

93. For example, Congress could redraft 11 U.S.C. § 522 to provide that the total exemptions allowed by the law of a state that opted-out could not exceed 125% or 150% of the federal exemption.

94. On May 9, 1995, Senator Kohl of Wisconsin introduced Senate Bill 769, seeking to amend Title 11, Section 522 of the United States Code. This amendment would limit to $100,000.00 the value of certain real and personal property that a debtor may elect to exempt under state or local law. The Bankruptcy Abuse Reform Act of 1995, S. 769, 104th Cong., 141 CONG. REC. 6344 (1995). The bill was referred to the Senate Committee on the Judiciary on the same day, and it has not resurfaced since.

95. Florida and Texas are notorious in this area. *See* Larry Rohter, *Rich Debtors Finding Shelter Under a Populist Florida Law*, N.Y. TIMES, July 25, 1993, at 1.

of a previous creditor who could have utilized the preceding exceptions; and instances involving a debtor who fraudulently procured funds for the purpose of investing in the homestead itself. Beyond the matter of fraudulently procured funds there is no express exception for a debtor's fraudulent conduct.[96]

In *Bank Leumi Trust Company v. Lang*,[97] the federal district court ruled that Florida's homestead exemption law precluded a creditor from executing against a recently purchased $522,000.00 home. The court issued this ruling despite a finding that the debtors involved purchased the home with the intent to defeat the creditor's claim.[98] The precise facts of the case warrant consideration. Prior to 1990, the debtors, Milton and Elena Lang, were New Jersey residents who owned an educational training business. In 1989, Bank Leumi Trust Company loaned the business $1,800,000.00, secured by corporate promissory notes and personal guarantees. The Langs' business filed for bankruptcy in 1989, and in April 1990, Bank Leumi sued the Langs in New Jersey to collect on the personal guarantees.[99]

The same month as the lawsuit commenced, the Langs purchased a home in Florida, paying $522,000.00 in cash. The following month, they purchased approximately $500,000.00 worth of annuities, which, in Florida, are statutorily exempt from execution by creditors. Bank Leumi obtained a judgment against the Langs in November 1990 (for all of the $1,800,00.00 loaned) and domesticated the judgment to Florida the following month. The bank thereafter filed a post-judgment petition seeking to enforce the judgment against the Langs' assets—specifically, the home and annuities.[100] The issues considered by the court were "whether the Langs purchased exempt assets in Florida in order to defraud their creditor[]" and "even if the purpose of these transactions was fraudulent in nature, whether the Langs [could] nonetheless avail themselves of the homestead exemption and the statutory exemption for annuities."[101]

Based primarily upon the timing of the transactions and the nature of the investments involved, the court concluded that the Langs had indeed converted their non-exempt assets into exempt assets for the sole purpose of hindering and avoiding their creditor and defeating their creditor's claims. Nevertheless, the court held that the Langs homestead was exempt from Bank Leumi's

96. Alvin L. Arnold and Marshall E. Tracht, *Fraud: Florida Homestead Exemption Still Applies*, 25 REAL EST. L. REP. 2 (1996).

97. 898 F. Supp. 883 (S.D. Fla. 1995).

98. *Id.* at 887.

99. *Id.* at 884.

100. *Id.*

101. *Id.* at 885.

execution request.[102] The court undertook an analysis of Florida case law on the homestead exemption:

> Plaintiff has not presented a Florida state case in which a Florida court has imposed an equitable lien upon a homestead as a result of a debtor's converting non-exempt assets into a homestead. Accordingly, although this Court is reluctant to place its imprimatur upon conduct which, beyond question, was an effort to delay, hinder or defraud, it is obligated to follow Article X, Section 4(a) of the Florida Constitution.[103]

The court reached a different conclusion with respect to the Langs' annuities. The exemption for annuities, although as broadly written as the homestead exemption, is statutory rather than constitutional. As a result, the *Bank Leumi* court and other Florida adjudicators have ruled that the exemption is not available when the annuities were purchased with the intent to delay or defraud a creditor.[104]

The case of *In re Miller*,[105] further illustrates the relative sanctity of the homestead exemption. Judge Paskay, author of the *Miller* opinion, held that, upon the facts presented, the debtor was entitled to a homestead exemption. Like so many others, this holding stood in the face of the debtor's clear purpose to convert non-exempt property and purchase a home to the hinderance and delay of creditors.[106] Similar to the Langs' annuity investment in *Bank Leumi*, the debtors in *Miller* utilized proceeds from the sale of nonexempt assets not only to purchase a homestead but also to pay loans against the cash surrender value of two life insurance policies.[107] Judge Paskay again found that the debtor's purpose in converting the proceeds from the sale of non-exempt assets was to hinder or delay creditors. In denying the debtor's claimed exemption of the cash value of the two life insurance policies, Judge Paskay reasoned as follows:

> Even a cursory comparison between the homestead exemption created by the Florida Constitution and the exemption created by Statute concerning annuities leaves no doubt there is one significant distinction and difference. This is that the protection granted to homestead is a constitutionally guaranteed right and lost only if the three specific and expressly stated exceptions are present. On the other hand, the exemption created for annuities is a creature of the Legislature, it has no constitutional protection,

102. *Id.* at 887.
103. *Id.* at 889.
104. *Id.*
105. Meininger v. Miller (*In re* Miller), 188 B.R. 302 (Bankr. M.D. Fla. 1995).
106. *Id.* at 308.
107. *Id.* at 304.

and therefore, may be subject to other exceptions, specifically an exception relating to the fraudulent transfer of non-exempt property into exempt property.[108]

Another tortured aspect of the sacred homestead was explained by Judge James F. Queenan, Jr. of Worcester, Massachusetts, in *In re Boucher*:[109]

> In light of the clear command of section 522(c) and the preemptive power of Congress under its constitutional authority to establish uniform bankruptcy laws, congressional approval of the use of state exemptions cannot be taken to extend to exemptions that protect debts left unprotected by section 522(c). Yet, Congress obviously wanted a debtor to have exempt property. The result is that the Debtor's election of the state exemption stands, but the state exemption for pre-homestead debts does not.[110]

Judge Queenan leaves his reader with a bit of a puzzle: "What clear command?"

Notwithstanding the erudite reasoning of *Bank Leumi, Miller,* and *Boucher*, it does not seem appropriate that a law, created to shelter a family from the elements, should be available to shelter fraudulently gained wealth from the reach of creditors. Whether or not homestead exemptions remain protected in fraudulent situations is not nearly as significant as whether or not the exempt value of a homestead should remain unlimited. Any decision as to limitation must, however, rest in the arthritic hands of legislature.[111] When it does come, the decision must fix a finite number; otherwise, we shall continue to read about exempted homesteads like Kuhn's one million dollar Florida palace[112] or the seventy million dollar tower of a Texas debtor.[113]

2. Annuities, Insurance and Pension Funds

Protecting an insurance policy for the benefit of a debtor's family (should the debtor die) and protecting annuity and pension incomes are sound public policies that should remain a part of the exemption law. The problem is, however, the same with these assets as it is with a homestead. How much is enough? Bankruptcy was intended to provide a fresh start, not instant

---

108. *Id.* at 308.

109. 203 B.R. 10 (Bankr. D. Mass. 1996).

110. *Id.* at 13.

111. It is far from comforting to realize the range of legislative options. Recall Senator Kohl's suggestion of a $100,000.00 limit, *supra* note 94, and compare that with the $15,000.00 exemption allowed under 11 U.S.C. § 522(d)(1).

112. *See supra* note 53.

113. *See NBC Nightly News* (NBC television broadcast, Jan. 17, 1992). Tom Brokaw interviewed a Texas debtor on the roof of a seventy million dollar, multi-story skyscraper which he was able to exempt as his homestead under Texas law. *Id.*

affluence. As long as many states allow these items to remain exempt in unlimited amounts the problem will continue. Congress must, therefore, also cap the value of annuities, insurance and pension funds that may be exempted.

3. Things and Stuff

As an act of additional charity, many states have added various things and stuff to the list of exemptions. Unfortunately, lawmakers gave little thought to the creativity of some debtors and their attorneys. The mistake is compounded by the failure to stipulate any value caps. True, probably every debtor needs an automobile, but does any debtor need a Rolls Royce? Every debtor may need the tools of his or her respective trade, but does a bankrupt violinist need a Stradivarius? It would be nice to allow every debtor to retain family jewels, but should that include the Hope Diamond? Again, the cap, the limit on individual or total exemptions, is the key to fairness and equity.

B. What About Timing?

If the purpose of exemptions is to provide a debtor with a fresh start, then establishing complex rules regarding the timing of conversions to exempt status only hinders the poorest debtors in setting aside and holding on to a nest egg. The millionaires and multi-millionaires with their expensive-and-effective-counselors will meet every timing requirement, while the poor, without legal advice or with the advice of less expensive and possibly less experienced and less skilled lawyers to guide them, probably will not. How important should the timing of a transaction be? Should it make a difference if the conversion to exempt status occurs the day before the petition is filed, or three months or twelve months before? Exemptions are not a game the winning of which is decided according to a petitioner's skill in asserting the Piggy Rule. Timing should not be a factor at all.

C. Exemption by Declaration

In *Taylor v. Freeland & Kronz*,[114] the Supreme Court addressed the consequences that would flow from a trustee's failure to object to a claimed exemption under 11 U.S.C. § 522(l) and Federal Rule of Bankruptcy Procedure 4003(b). The debtor in the case, Emily Davis, filed a voluntary petition under Chapter 7 of the Bankruptcy Code while simultaneously pursuing an employment discrimination claim against Trans World Airlines (TWA) in state court. Davis listed the lawsuit with an unknown value on her personal property schedule and also claimed the proceeds of same as exempt.[115]

114. 503 U.S. 638 (1992).

115. *Id.* Davis described the property as "[p]roceeds from lawsuit--Davis v. TWA" and

Robert J. Taylor became the trustee of Davis' bankruptcy estate. In January, 1995, Taylor held the required 11 U.S.C. § 341 meeting of creditors. During the meeting, Wendell G. Freeland, Richard F. Kronz, and their law firm (which represented Davis in her discrimination suit) advised Taylor that Davis might win $90,000.00 in her suit against TWA. Several days after the meeting, Taylor wrote a letter to Freeland & Kronz requesting additional information about the suit and advising the firm that he considered any recovery resulting from Ms. Davis's lawsuit to be property of the estate. Freeland & Kronz informed the trustee that the case might settle for the sum of $110,000.00.[116]

Although Taylor knew that Davis claimed the proceeds of the lawsuit as exempt, he believed that the suit lacked substantial value. Therefore, he declined to pursue the asset and did not object to the debtor's claim. The fact that there is no exemption for "proceeds of a lawsuit" apparently was of no importance since, in Taylor's opinion, a sustained objection to the claimed exemptions would not have made a significant difference in the total value of the estate.[117] As stated by Justice Thomas, "Taylor proved mistaken."[118]

In October, 1986, the Pennsylvania Supreme Court affirmed the Commonwealth Court's determination that TWA had discriminated against Davis. TWA settled the suit for the sum of $110,000.00. Freeland & Kronz received the only liquid portion of this amount, approximately $71,000.00, as payment of their legal fees.[119] Taylor subsequently filed a complaint in the Bankruptcy Court, demanding that the firm turnover the $71,000.00 because it constituted property of Davis' bankruptcy estate. Freeland & Kronz argued that they could keep the fees because Davis had claimed the proceeds of the lawsuit as exempt and Taylor failed to object to the claimed exemption in a timely manner.[120]

The bankruptcy court concluded that the debtor had no statutory basis for the exemption and ordered the return of approximately $23,000.00 to Taylor.[121] The United States District Court for the Western District of Pennsylvania affirmed, but the United States Court of Appeals for the Third Circuit reversed.[122] The court of appeals accepted Freeland & Kronz's argument that return of the money was not due because Davis had claimed it as exempt and Taylor had failed to object to the claimed exemption in a timely manner:

"[c]laim for lost wages." *Id.*

116. *Id.*

117. *Id.* at 641.

118. *Id.*

119. *Id.*

120. *Id.*

121. The $23,000.00 sum was sufficient to pay all outstanding creditors. *Id.*

122. *Id.*

> We will adhere to the clear and orderly scheme Congress enacted for property exemption determinations and hold that in the absence of an objection filed within thirty days after the section 341(a) creditors' meeting or the filing of an amendment to the exemption list, property claimed as exempt by the debtor is exempt.[123]

The Supreme Court affirmed the decision of the court of appeals, concluding that the trustee could not contest the exemption regardless of whether the *claimed* exemption had a colorable basis.[124] Without exception, all parties agreed that neither state nor federal law permitted an exemption of any significant part of such a recovery.[125] Yet, the Supreme Court held that absent a request for an extension of time, Rule 4003(b) of the Federal Rules of Bankruptcy Procedure places a thirty-day limit upon the trustee and creditors to object to the claimed exemptions of a debtor in bankruptcy. Moreover, Bankruptcy Rule 4003(b) must be read in conjunction with 11 U.S.C. § 522(l), which provides that the property claimed as exempt shall be exempt unless an objection to said exemption has been timely filed.[126]

The Supreme Court created a windfall for opportunistic debtors. What is more, rather than permitting bankruptcy courts to address the consequences of the opinion, the Court explicitly placed the burden upon Congress to address the potential for abuse inherent to the *Taylor* decision:

> Debtors and their attorneys face penalties under various provisions for engaging in improper conduct in bankruptcy proceedings . . . . These provisions may limit bad-faith claims of exemption by debtors. To the extent that they do not, Congress may enact comparable provisions to address the difficulties that Taylor predicts will follow our decision. We have no authority to limit the application of § 522(l) to exemptions claimed in good faith.[127]

To date, it appears that Congress has not assumed the burden identified in *Taylor*. And the courts and trustees continue to face the question of what can be done to prevent, if not diminish, the potential for abuse.

Here again, we see the mischief created by an ability to include an asset by name rather than amount. Capping total exemptions would cure this problem along with the others described above.

---

123. Taylor v. Freeland & Kronz, 938 F.2d 420 (3d Cir. 1991), *aff'd*, 503 U.S. 638 (1992).

124. *Taylor*, 503 U.S. at 643-44.

125. *Id.* at 642; *see also* Addison v. Reavis, 158 B.R. 53 (E.D. Va. 1993).

126. *See Taylor*, 503 U.S. at 643.

127. *Id.* at 644-45 (citations omitted).

VI. CONCLUSION

The exemption issue should be quickly and simply resolved at the bankruptcy court level. On appeal, the standard for reversal is clear error. Thus, the likelihood of reversing the bankruptcy court on appeal is slim. This paper was designed to illuminate several perplexing issues in the bankruptcy planning realm—issues that should, in particular, be dealt with at the bankruptcy court level. We conclude with a summary of those issues and our thoughts as to current treatment and future resolution.

A. Where Does the Pre-Bankruptcy Planning Road Start?

Should scrutiny come to bear within a certain number of days before filing? (Ninety days, a year before filing the voluntary petition, five years?) Or does pre-bankruptcy planning commence when you first consult with a lawyer or a bankruptcy lawyer?

To date, Congress has not set precise time limits on pre-bankruptcy exemption planning. As a rule of thumb, the more remote in time from the date of the filing, the better the chance that the structuring will be determined to be legitimate planning, rather than hindering, delaying or defrauding creditors. Unfortunately, most debtors in the lower economic strata do not receive legal advice until disaster is at hand and the filing date is near. Most cases seem to ignore the date a debtor first consulted a lawyer and whether the lawyer was a general practitioner or a bankruptcy specialist. Advice of counsel also does not excuse the debtor if the court disagrees with the legal advice. If bankruptcy is to provide the fresh start for the honest poor person, time should not be a part of the equation, with the possible exception of structuring which occurs within fifteen or thirty days of the date the petition is filed.

B. What Is the Relevance of Solvency?

Solvent persons seldom file bankruptcy. What a solvent person does with his or her assets is a matter of free choice unless the gift or disposition of assets renders the solvent person insolvent; however, that situation should be subject more to resolution under existing laws relating to fraud.

Bankruptcy occurs not because a debtor is solvent, but because a debtor is insolvent or about to become insolvent. Thus, the concept of pre-bankruptcy planning generally involves the conversion of non-exempt property to exempt property on the eve of a bankruptcy filing. Courts are split on the issue of conversion (non-exempt property to exempt property) during insolvency. For example, in the Eighth Circuit, conversion of non-exempt property to exempt property while insolvent is not evidence of fraudulent intent as to creditors,[128] but in New Mexico, self induced insolvency is not protected under the state exemption statute.[129]

If the purpose of bankruptcy is a fresh start for the honest debtor, then the focus should be on establishing a finite, modest dollar amount that a debtor may keep through bankruptcy. Mere insolvency is not per se an immoral act; fraud is. The issue of solvency should be omitted from the exemption battle ground as long as total exemptions are finite and modest and actual fraud is not involved.

C. How Do You Determine the Actual Intent To Defraud Creditors? Do the Badges of Fraud Provide Any Help or Guidance?

The badges of fraud are indeed helpful in some cases to establish intent to defraud creditors.[130] Generally, however, the trustee or a creditor is left to the good old-fashioned way of proving fraud—pleading the fraudulent conduct with specificity and thereafter proving the fraudulent conduct. In his article entitled *Exemption Limitations: Political and Ethical Considerations*, Judge William Houston Brown outlines "other indications of fraudulent intent that have been expressed by some courts." These indications include "a systematic conversion of assets;" conversion of nonexempt to exempt status immediately after acquisition of a forbearance agreement with a major creditor; acquisition of exemptions after creditor collection efforts; acquisition

---

128. *See* Hanson v. First Nat'l Bank, 848 F.2d 866, 868 (8th Cir. 1988).

129. *See* Albuquerque Nat'l Bank v. Zouhar (*In re* Zouhar), 10 B.R. 154, 157 (Bankr. D.N.M. 1981).

130. In *Meininger v. Miller* (*In re* Miller), 188 B.R. 302, 305 (Bankr. M.D. Fla. 1995), the court delineated eleven factors under Florida Statute Section 726.105(2) to consider in determining actual intent. These eleven factors parallel those set forth in the Uniform Fraudulent Transfer Act and include the following:

(a) The transfer or obligation was to an insider.
(b) The debtor retained possession or control of the property transferred after the transfer.
(c) The transfer or obligation was disclosed or concealed.
(d) Before the transfer was made or obligation was incurred, the debtor had been sued or threatened with suit.
(e) The transfer was for substantially all of the debtor's assets.
(f) The debtor absconded.
(g) The debtor removed or concealed assets.
(h) The value of the consideration received by the debtor was reasonably equivalent to the value of the assets transferred or the amount of the obligation incurred.
(i) The debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred.
(j) The transfer occurred shortly before or after a substantial debt was incurred.
(k) The debtor transferred the essential assets of the business to a lienor who transferred the assets to an insider or the debtor.

of exempt assets with credit purchases; acquisition of exemptions that have an unlimited dollar amount such as a homestead; acquisition of exemptions with the primary motive of shielding the assets from creditors; claiming an unreasonably large number of exemptions; acquisition of exemptions that rendered the debtor insolvent; conversion on nonexempt to exempt assets after the filing of the case; and in the event of transfers to third parties, transfers that were gratuitous, for less than adequate consideration, to family members, or undisclosed.[131]

D. What Should a Lawyer Advise and What Should a Debtor Try to Exempt?

Unfortunately, the congressional intent regarding what is allowed in bankruptcy and what is not has been interpreted so differently by judges throughout the United States that each new case just adds to the muddle.

Yet, the following general trends have emerged:

- If a choice exists, non-exempt assets converted to a homestead have a better chance of remaining exempt than those converted to any other exempt category of asset.
- Conversion to exempt assets which may themselves be readily converted to cash are not likely to remain exempt and may even threaten the debtor's discharge as a whole.
- Advice of counsel does not seem to have a significant effect on the decision of the Court.
- Insolvency and an imminent or pending lawsuit or an existing judgment against the debtor appear to support findings of intent to hinder, delay or defraud creditors.
- Conversions days or weeks before filing a petition are clearly more suspect than conversions months or years before filing.
- Suits alleging a fraudulent transfer seldom succeed because in such a conversion technically there is no transfer as the Bankruptcy Code defines the term. Objections to exemptions seem to be a creditor's best remedy. Even when the objection is overruled, there are many cases of a discharge thereafter being denied under 11 U.S.C. § 727(a)(2).
- Denial of discharge, however, seems to be a rather unsatisfactory remedy. It leaves the debtor still in possession of the asset which is exempt under state law, and the prospect of continuing litigation at the state level looms large. The better remedy would be a sustained

131. William Houston Brown, *Exemption Limitations: Political and Ethical Considerations*, *in* 70TH ANNUAL MEETING OF THE NATIONAL CONFERENCE OF BANKRUPTCY JUDGES, 7-5, at 7-35 (1996).

objection to exemption and the trustee's subsequent ratable distribution to all creditors.

Under the present state of the law the answer to the question "how far may you go?" is, you may go as far as you can.