Estate Planning – When does a pig become a hog?

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ESTATE PLANNING - WHEN DOES A PIG BECOME A HOG?

It is not uncommon for Debtors facing insurmountable financial hardships to "plan" for a possible Bankruptcy filing or simply "maneuver" their assets to attempt to become judgment proof. How much planning is too much? How far can a Debtor "push the envelope" to keep assets from creditors? This is one of the most difficult discussions an attorney can have with his or her clients and requires a great deal of thought and analysis in order to assist the client in making a decision with which the client has confidence or at least understands the risks of planning.

In our hypothetical situation, our potential debtors have purchased a large homestead and have loaded up on their IRAs and 401(k) plans. Have they pushed the envelope too far? Will these assets be protected if they file for bankruptcy? Are they risking their discharge? What information do we still need to know and what do we need to discuss with our clients?

Of course, any discussion of "exemption planning" must start with an analysis of what exemptions will be available to our clients. This is not always a simple question and that inquiry was made even more complicated by the enactment of BAPCPA in 2005. The first question to ask our clients concerns their residence and domicile for the two-year period leading up to the bankruptcy filing. Have they lived in the jurisdiction for the entire two years prior to filing? If so, then they will be entitled to use the exemption scheme of the state in which they live and are filing their bankruptcy. If the state is an opt-out state, then they will use the exemptions of that state. If it is not, then they will use the Federal exemptions. Maybe they will be able to choose one or the other. Local state law will determine the answer.

If they did not live in the state for the two-year period, the analysis becomes complicated. 11 U.S.C.522 (b)(3)(A) requires that a Debtor live in the jurisdiction for 730 days (beware of leap years!) to be entitled to claim the exemptions of that jurisdiction. If the Debtor was not domiciled in that jurisdiction for the 730-day period, then the Debtor uses the exemptions of the state in which he or she was domiciled for the majority of the 180 days prior to the 730-day period (two and a half years). However, if that jurisdiction would require that the debtor actually be domiciled (or a resident) in the state in order to claim that state's exemptions, then the Debtor would use the Federal Exemptions (since otherwise the Debtor would have no exemptions available). Residency is not the same as domicile. *See* In Re Urban, 375 B.R. 882 (9th Cir. BAP 2007).

Since exemptions vary from state to state it is not possible to make a general statement as to whether putting equity into a house or an IRA is a safe thing to do. Homestead exemptions vary widely from state to state. Some states have unlimited homestead exemptions (Florida and Texas being two of the more famous ones) and others have very low (Tennessee has a $5,000 homestead exemption). IRA exemptions also vary (since an IRA is not ERISA qualified for the anti-alienation provisions, state or federal bankruptcy exemptions will determine if an IRA is exempt). Having once determined what exemption laws will apply, counsel can now discuss with their client the propriety of exemption planning on the eve of bankruptcy.

I will make a few assumptions about our Debtors in the hypothetical. I will assume that they did not borrow money for the purpose of building up their equity in exemptions. Borrowing money for the purpose of increasing equity in exemptions is one of the "badges of fraud" that is likely to result in the disallowance of an exemption or even the denial of a

discharge or the dischargeability of a debt. I will also assume that the amount used to build the exemption "nest egg" is significantly less than the amount of debt which the clients seek to discharge. While not necessarily a "badge of fraud", maneuvering assets of a value less than an amount needed to satisfy debts usually leaves a bad taste in a Court and is a strong factor which can tip the scales in favor of disallowing exemptions.

When does a pig become a hog? *See* <u>In re Blackburn</u>, 2007 WL 5582054 (Bankr. M.D. Tenn. 5/1/2007). Many courts rely upon the old adage "Pigs get fat and hogs get slaughtered" in examining exemption planning. The line is a very difficult one to walk and clients must understand the risks that they take in engaging in extensive exemption planning. Consider the fate of two doctors in Minnesota- Dr. Tveten (<u>Norwest Bank Nebraska v. Tveten</u>, 848 F.2d 871 (8th Cir. 1988)) and Dr. Johnson (<u>In re Johnson</u>, 880 F.2d 78 (8th Cir. 1989)). Each of these debtors converted extensive assets ($700,000 for Dr. Tveten and $400,000 for Dr. Johnson) from non-exempt to exempt. Each filed for Bankruptcy relief. Dr. Johnson was granted a discharge. Dr. Tveten was denied his. Each had engaged in the same activity. Each case was ultimately decided by the 8th Circuit Court of Appeals. In each case, the Court of Appeals determined that the issue-entitlement to a discharge-was within the discretion of the Bankruptcy Court and could not be reversed except for abuse of discretion. A third case from the 8th Circuit, <u>In re Hanson</u>, 848 F.2d 866 (8th Cir. 1988), argued the same day as Tveten and before the same panel, resulted in a South Dakota farmer saving his exemptions and his discharge for pre-bankruptcy planning in an amount far less than that of either Dr. Tveten or Dr. Johnson. It is impossible to reconcile these decisions. All counsel can do is explain these cases to the client and let the client make an informed decision. Sending the client a detailed letter

explaining the case law and the risks will allow the client to review his or her options prior to making a decision and will also provide backup for the attorney should things go bad and a client not be happy with the outcome.

It has been frequently recited by Bankruptcy Courts that the conversion of non-exempt property to exempt property, in and of itself, is not indicative of a fraudulent conveyance even if the Debtor is insolvent or is rendered insolvent by the transfer. *See* <u>In re Elia</u>, 198 B.R. 588 (Bankr. D. Ariz. 1996); *see also* <u>In re Stern</u>, 345 F.3d 1036 (9th Cir. 2003), in which the Debtor transferred a non-exempt IRA into an exempt pension plan on the eve of Bankruptcy. The Ninth Circuit has held, since at least 1971, that the conversion of non-exempt assets to exempt assets without some additional element of fraud is not per se fraudulent. *See* <u>Wudrick v. Clements</u>, 451 F.2d 988 (9th Cir. 1971).

Courts have reviewed these types of transactions in order to evaluate whether a fraudulent conveyance has occurred. What type of extrinsic conduct would give rise to extraneous evidence of fraud? Judge Haines of the Arizona Bankruptcy Court, in <u>In re Crater</u>, 286 B.R. 756 (Bankr. D. Ariz. 2002), made an exhaustive analysis of various factors which might give rise to a finding of a fraudulent conveyance:

(1) Was the transfer made to an "insider?"

(2) Did the Debtor retain possession or control of the property transferred?

(3) Was the transfer disclosed?

(4) Before the transfer was made, had the Debtor been sued or threatened with suit?

(5) Was the transfer all or substantially all of the debtor's assets?

(6) Did the Debtor abscond?

(7) Did the Debtor remove or conceal assets?

(8) Was there adequate consideration?

(9) Did the debtor become insolvent after the transfer?

(10) Did the transfer occurred shortly before or after a substantial debt was incurred?

After listing the elements, Judge Haines then categorized them into three types of "badges". Is the conduct indicative of fraudulent intent (such as concealment of the property or concealment of the transfer, or retaining possession of the property, absconding)? Was there some motivation other than the transfer itself due to lack of economic benefit (transfer to insider, less than equivalent value, transferring all or most of a business's assets)? The third category reflects timing factors (when was the transfer made in relation to litigation or the incurring of a debt, whether it transferred all or most of the Debtor's assets, whether it rendered the Debtor insolvent).

Other Circuit Courts of Appeal have reached a similar conclusion to that of the Ninth Circuit. There is no per se prohibition against the conversion of nonexempt assets into exempt assets. *See* <u>In re Addison</u>, 540 F.3d 805 (8th Cir. 2008); <u>In re Bowyer</u>, 932 F.2d 1100 (5th Cir. 1991); <u>Midland Business Loans, Inc. v. Carey</u>, 938 F.2d 1073 (10th Cir. 1991); <u>In re Hanson</u>, 848 F.2d 866 (8th Cir. 1988). The transfer of those assets does not give rise to a fraudulent conveyance even where the transferor is the Debtor.

Clearly, disclosure is a key element. Make sure that the conversions of any non-exempt assets to exempt assets are fully disclosed on the Statement of Financial Affairs as a transfer made within two years. It is the only place where the Debtor can make this disclosure. The Debtor should keep records of what was transferred, to whom and for what consideration. Transfers to family members are likely to raise eyebrows by trustees

and creditors, as are transfers for less than fair value. If the Debtor sells an asset, he or she should relinquish possession and control of the asset. Keeping control of an asset which the Debtor claimed to have transferred is one of the "badges of fraud" which can result in a denial of discharge as well as the loss of the exemption. Counsel is admonished to "know your judge" and research local case law in determining if your courts are likely to consider issues of timing and amounts transferred in determining whether to allow or deny an exemption or a discharge.

There are complicating issues when analyzing pension exemptions. A plan which is "ERISA qualified" is going to be considered as non-estate property since it contains anti-alienation provisions and is specifically excluded from property of the estate under 11 U.S.C. § 541(b)(7). An IRA is not "ERISA qualified" under Title I of ERISA and is therefore subject to the exemption provisions of § 541(b)(5) or applicable state or Bankruptcy exemption laws. What if a plan is not "tax qualified" but contains appropriate anti-alienation provisions? In other words, does a plan lose its otherwise exempt status because of issues such as over-funding or improper investing? Is the plan a self-directed IRA? Is it a 401(a) plan? IRA's are subject to disqualification more easily than 401 plans. Counsel should be especially careful if a client has a "self-directed IRA" since it is very easy to make a disqualifying investment. *See* <u>In re Williams</u>, 2011 WL 10653865 (Bankr. E.D. Cal. 2011); <u>In re Willis</u>, 2009 WL 2424548 (Bankr. S.D. Fla. 2009). Read carefully the state exemption laws (if state law applies) if the pension plan in question is not a ERISA plan. The language of a state statute may be a critical importance. *See* <u>In re Bauman</u>, 2014 WL 816407 (Bankr. N.D. Ill. 2014); <u>In re Rucker</u>, 570 F.3d 1155 (9th Cir. 2009); <u>In re Richey</u>, 2011 WL 4485900 (9th Cir. BAP 2011). Counsel needs to consult with tax and/or

pension law counsel before making recommendations to a client to file for Bankruptcy and to claim a questionable pension as exempt. It is often a Debtor's most valuable asset and can be a target for aggressive creditors or trustees.

In our hypothetical situation, our clients have invested assets into a homestead and various pension accounts. One issue to consider is whether they should even file for Bankruptcy protection. Are they otherwise uncollectible? Are they self-employed? Are they in a service industry where wages are difficult to attach? What other collection remedies are available to creditors in a non-Bankruptcy forum? Do you want to expose your clients to a trustee who "eats what he kills?" Can Bankruptcy be deferred for two years to get past the disclosure requirements? Are you better off litigating exemption issues against one creditor as opposed to the entirety of a Bankruptcy estate? If you live in an "opt-out" state, the exemptions will be the same. If you are in a state that has not opted out, are state exemptions better for your client than the Federal exemptions? If your client has not lived in the state for two years, are you better off with the exemptions they will be using in Bankruptcy or the exemptions of your state?