What Estate Planning Lawyers Should Know About Bankruptcy Law

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EXECUTIVE SUMMARY:

Many estate planners are familiar with asset protection mechanisms, such as state law exemptions, family limited partnerships (FLPs), offshore asset protection trusts (OAPTs), and domestic asset protections trusts (DAPTs). They also are acquainted with some creditor protection rules such as state fraudulent transfer acts as well as ethical considerations that apply to creditor protection planning. Many advisors also have some knowledge of the U.S. Bankruptcy Code.

Unfortunately, though, even those advisors who are familiar with portions of the Bankruptcy Code are unaware of certain provisions—such as those governing preferential transfers—that can have a catastrophic effect upon an estate plan. Indeed, many estate tax- and income tax-oriented planning structures risk being dismantled by a bankruptcy judge, even though the plan's primary purpose had nothing to do with creditor protection.

That is why it is critical to not only know the basics, but also to recognize certain rules that apply in the bankruptcy forum and the need to consult with a bankruptcy lawyer in certain situations. The following information will provide an update, review, or excellent introduction to this most important segment of financial services.

FACTS:

THE BASICS

Any estate planning client could end up in a bankruptcy proceeding, whether voluntarily or involuntarily. In many cases, it is unlikely that a client would choose to file a voluntary bankruptcy petition. Often, a client may be forced into a bankruptcy proceeding on an involuntary basis.[1] And since the implementation of the 2005 Bankruptcy Abuse Prevention and Creditor Protection Act (2005

[1] 11 U.S.C. Section 303 (2007).

Bankruptcy Act), there are more stringent requirements imposed on consumer debtors that must be met for them to be eligible to file a petition.

In general, there are three types of bankruptcy:

Chapter 7 is essentially a liquidation mechanism.
Chapters 11 and 13 contemplate a repayment plan.

A Chapter 7 debtor must meet a "means test." Upon filing a petition to implement an automatic stay against creditor actions, a Chapter 7 trustee is appointed and the assets become property of the bankruptcy estate, many of which may qualify as exempt. In Chapter 7, the court essentially takes a snapshot of the debtor's assets and liabilities as of the date of filing.

A court may dismiss a case that is filed under Chapter 7 of the Bankruptcy Code when the debts are primarily consumer based.[2] The term "consumer debt" is defined as a debt incurred by an individual primarily for a personal, family, or household purposes.[3]. Whereas, a business debt is one where the individual would expect some profit from the acts that led to the judgement.[4] A Court will use a means based test that will force consumer debtors out of Chapter 7 liquidation and into Chapter 13.[5] A tort liability judgment is not considered a consumer debt.[6]

This is significant because the debtor's post-petition earnings are not property of the estate. For example, if a debtor won the lottery post-petition, the lottery winnings would not be property of the estate. Typically, 90 days from filing, the debtor obtains a discharge from responsibility for pre-bankruptcy debt. The debtor is afforded a fresh start. However, there are some exceptions to the discharge rule. For instance, only individuals receive a discharge, not corporations. Other debts excluded from discharge include claims not listed by the debtor on the schedules, certain taxes, and domestic support obligations.

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[2] 11 U.S.C.A. § 707(b)(1) (West).

[3] 11 U.S.C.A. § 101(8) (West).
[4] In re Peterson, 524 B.R. 808, 812 (Bankr. S.D. Ind. 2015).

[5] David Gray Carlson, Means Testing: The Failed Bankruptcy Revolution of 2005, 15 Am. Bankr. Inst. L. Rev. 223, 228 (2007).
[6] In re Peterson, 524 B.R. 808, 812 (Bankr. S.D. Ind. 2015).

Chapter 13 is only available to individuals (not corporate or other business entities). To be eligible to file a Chapter 13, an individual must have unsecured debts of less than $383,175 and secured debts of less than $1,149,525.[7] Chapter 13 repayment plans are for three to five years and are funded by the debtor's disposable income. In exchange for paying under a Chapter 13 plan, a debtor keeps his or her assets. Chapter 13 is prospective as opposed to the snapshot concept of Chapter 7. The Chapter 13 trustee administers payments under a plan once a court confirms the plan. At the conclusion of the plan, after payments are made, the debtor obtains a discharge.

Chapter 11 is used primarily for business entities, but individuals with significant assets or who do not meet the debt limits for Chapter 13, may file a Chapter 11. Instead of a trustee, the debtor becomes the debtor-in-possession (DIP) and is afforded an opportunity to propose a plan. The DIP remains in possession and control of her assets. Chapter 11 requires the debtor to obtain the vote of creditors in order to confirm the plan, unless the debtor is able to "cramdown" the plan as authorized by the Code. The cramdown rules allow the bankruptcy judge to approve the debtor's plan over the objections of dissenting creditors. The cramdown is only permitted if the plan does not discriminate unfairly, and is fair and equitable to the dissenting classes.

Estate planners should become well-versed in the nuances of these three types of bankruptcies, because significantly different results could occur depending on what chapter applies. For instance, in the case of the lottery winnings, if the winnings were obtained post-petition in a Chapter 7, the debtor would keep the winnings. On the other hand, if the winnings occurred while in a Chapter 13 or Chapter 11, the winnings are property of the estate.

Moreover, the application of the attorney/client privilege differs depending on whether a client files for Chapter 7, 11, or 13. When a Chapter 7 bankruptcy petition is filed, the Chapter 7 trustee may become the owner of the attorney/client

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[7] 11 U.S.C. Section 109(e) (2010).

privilege, as well as all client files for purposes of asserting or waiving the privilege. There is a split of authority on this point.[8]

Therefore, correspondence to the client that may reveal significant risks or adverse issues with respect to potential creditor planning might cause irreparable damage to the client, and the estate planner, if and when a bankruptcy petition is filed. However, the above privilege issue would not arise in the context of a Chapter 13 or Chapter 11 bankruptcy.

INVOLUNTARY BANKRUPTCY

It only takes *one* creditor to force a debtor into involuntary bankruptcy when the debtor has fewer than 12 creditors. Under 11 U.S.C. Section 303, when a debtor has 12 or more creditors, an involuntary bankruptcy can be commenced only when 3 or more creditors file a petition, with each creditor holding a claim that is (1) not contingent as to liability, and (2) not subject to a bona fide dispute as to liability or amount.

A creditor cannot be counted in the three-or-more-creditor requirement if it holds a lien on the debtor's property, unless its claim exceeds the value of the property liened by at least $12,300. Generally, employees and "insiders" are not counted as creditors in determining whether 12 creditors exist. Because of the stricter bankruptcy rules, which are now applicable, more clients with large judgments against them will be rendered insolvent, yet will attempt to avoid or delay bankruptcy while maintaining their creditor exempt assets. Creditors may respond by utilizing the involuntary option.

There have been many notable decisions, including one by the U.S. Court of Appeals for the Fifth Circuit in *Denham v. Shellman Grain Elevator*,[9] where the

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[8] *Community Futures Trading Comm'n v. Weintraud*, 471 U.S. 343 (1985), held that a trustee may waive the attorney client privilege for a corporate Chapter 7 debtor, but it did not extend its holding to individual debtors. *See Miller v. Miller*, 247 B.R. 704 (Bankr. D. Ohio 2000), discussing the split of authority.

[9] *Denham v. Shellman Grain Elevator*, 444 F.2d 1376 (5th Cir. 1971), the debtor listed 18 creditors with an aggregate indebtedness of only $467.13, all but one of whom were owed less than $100, to defeat an involuntary petition for bankruptcy filed by one of Denham's very large creditors. The court found that all of the debts were open and unliquidated, as opposed to claims reduced to judgments, and that small recurring debts cannot qualify creditors to be counted toward the necessary amount required to initiate a petition.

bankruptcy court refused to count small and recurring claims as "countable" under the 12 creditors requirement. One Florida bankruptcy case, *In re Smith*, cited *Denham* and excluded creditors holding *de minimis* claims for $20-$275.[10] Other cases have permitted claims of $65 and $10 to be countable under Section 303 requirement that the aggregate claims must equal or exceed $12,300.

The courts that have chosen not to follow *Denham*, and to instead allow small and recurring claims to count, have dismissed the *de minimis* exception as an argument to disqualify one or more creditors, based upon the argument that Congress has not explicitly ruled out small and/or recurring debts and the statute,[11] therefore, should be applied literally.[12] Some courts, however, such as the court in *Matter of Runyan* have indicated that a $25 debt would not be sufficient, and will evaluate the claims on a case-by-case basis.[13]

Filing an involuntary petition is an aggressive creditor strategy and there are serious and costly consequences if the petition is dismissed. A creditor who files for an involuntary bankruptcy "in bad faith" can be forced to pay the debtor's fees, costs and actual and punitive damages.[14] In *In re Cannon Express Corporation*,[15]

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10 *See In re Smith*, 123 B.R. 423 (M.D. Fla. 1990).

11 11 U.S.C. Section 303(b)(2) (2007).

12 *See In re Okamoto*, 491 F.2d 496 (7th Cir. 1974) which allowed eight debts, all of which were below $65 each, to count toward the 12 creditor threshold and stated that most courts abandon *Denham* because *Denham* refused to acknowledge Congressional intent by specifically differentiating between large and small debts and removing a prior provision excluding debts below $50; *See Matter of Rassi*, 701 F.2d 627 (7th Cir.1983) which prevented the petitioner from forcing the debtor into an involuntary bankruptcy by allowing two claims, both $10 or less; *See also* 11 U.S.C. Section 548(e); *See also* Steve Leimberg's Estate Planning Newsletter Number 485 by Alan S. Gassman.

13 *Matter of Runyan*, 832 F.2d 58 (Tex. Court App. 1987).

14 11 U.S.C. § 303(I) (2007).

15 280 B.R. 450 (Bankr. D. W.Ark. 2002).

the U.S. Bankruptcy Court for the Western District of Arkansas awarded compensatory damages and punitive damages where three creditors filed involuntary bankruptcy proceedings against debtor and the court found them to be in bad faith.

The decision was based on a combination of 5 tests identified in *In re Landmark Distributors, Inc.*[16] The *Cannon* court combined[17] and restated the tests finding that:

1. the claims were not well grounded in fact because the creditors did not speak with an attorney, talk to other creditors or attempt to collect the money from the debtor directly;

2. the creditors could have advanced their own interests in a different forum by using a collections agency or setting up a payment system with debtor or other forum, instead holding that using bankruptcy courts is an improper use of judicial resources;

3. the creditors used the bankruptcy proceedings to gain a disproportionate advantage over other creditors because the creditors, who were unsecured, testified that they thought filing involuntary bankruptcy proceedings would put them ahead of other unsecured creditors, thus gaining priority; and

4. the creditors were motivated, the court held, by an improper use because the creditor "knew that he was not going to be paid" but thought filing would force the debtor to make payment. Finally, the court held no other reasonable person would have filed the same or similar claim without first

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16 189 B.R. 290,309-10 (Bankr. D.N.J. 1995).

17 Those five tests are 1) the improper use test which finds bad faith if a creditor files involuntary bankruptcy to gain a disproportionate advantage for himself over other creditors, 2) the improper purpose test which finds bad faith if creditor's motivation for filing is ill will, malice or harassment, 3) the objective test which asks if a reasonable person would have also filed involuntary bankruptcy, 4) the subjective test which looks at the subjective motivation of the creditor (almost identical to the improper purpose test), and 5) the two part test which combines the subjective and objective tests. *Cannon* at 453.

investigating whether or not the debtor was paying its debts on time or attempting to collect the debts in some other fashion. For the improper filing the court awarded more than $14,000 compensatory damages and $35,000 in total punitive damages. Had the debtor proven losses in sales by preponderance of the evidence, the court would have awarded these damages as well, which were to be $2,768,288.00 according to the debtor.

In re Adell, 321 B.R. 562 (Bankr. D. Fla. 2005) is a good example of an involuntary bankruptcy filing that backfired on the petitioning creditor and resulted in the petitioning creditor becoming a debtor! In *Adell*, a bankruptcy court in Michigan dismissed an involuntary petition which was filed by Mr. Adell against his former builder. The Court awarded sanctions in the amount of $6,413,230.68 against Adell. Adell then quickly moved to Naples Florida and filed a Chapter 11 bankruptcy petition. Substantial litigation ensued resulting in the conversion of the Chapter 11 case to a Chapter 7 and ultimately the dismissal of the Chapter 7 case for substantial abuse.

The Bankruptcy Code can affect an estate plan if your client is a debtor, a recipient of a transfer from a debtor, or has an interest in a debtor. In general, upon filing a bankruptcy, assets of a debtor become property of the estate 11 U.S.C. Section 541. Some assets are specifically excluded, such as an interest in a spendthrift trust, as defined in 11 U.S.C. Section 541(c)(2) or social security or veterans benefits under 11 U.S.C. Section 522(d)(10)(a) and (b). If your client is a debtor, a recipient of a transfer from a debtor, or has an interest in a debtor, then bankruptcy law can dramatically affect the estate plan.

During pre-bankruptcy planning, advisors need to consider whether to leave assets in an estate that would become accessible to a trustee in bankruptcy. On one hand, there is less likelihood that transfers made before the filing of bankruptcy would be considered "fraudulent," when remaining assets that would be usable to pay creditors were, arguably, sufficient to pay a substantial portion of expected debt.

Also, courts may be sympathetic to situations in which debtors have lost "sacrificial lambs" as a part of their bankruptcy filings.[18] Judges may be more lenient in

[18] A common refrain from bankruptcy lawyers regarding this topic is that "pigs get fat and hogs get slaughtered." Leaving a sacrificial lamb may tip the scales more favorably towards a debtor since the perception of treating creditors

looking at fraudulent transfer and other issues with debtors who lose some assets upon filing bankruptcy, as compared to clients who have moved all of their assets to the exempt category and at filing show no assets going into the bankruptcy estate.

On the other hand, if a trustee has funds derived from bankruptcy estate assets to spend on attorneys' fees and costs to pursue a debtor or recipient of a transfer, it is more likely that the bankruptcy or pre-bankruptcy transfers will be challenged. Often, creditors do not want to "throw good money after bad," so some planners believe that only enough money to pay a small distribution is appropriate to leave in the debtor's name in the event of a bankruptcy.

JUDICIAL POWERS

Bankruptcy courts are courts of equity, able to fashion broad and extensive remedies typically not available to state court judges. For instance, under 11 U.S.C. section 105 of the bankruptcy Code, bankruptcy judges can enter "any order, process or judgment that is necessary and appropriate to carry out the provisions of this title." In addition to equitable powers, bankruptcy trustees are empowered with certain "strong arm powers" under the Bankruptcy Code. Presumptions concerning fraudulent transfers and avoidance of transfers are built into the Code, for instance in 11 U.S.C. Section 548 (fraudulent transfer) and in 11 U.S.C. Section 547 (preference), which are described below.

As a matter of bankruptcy law, a trustee is the equivalent of a hypothetical judgment creditor, and the court can step into the shoes of creditors to exercise statutory strong-arm powers to set aside and recover transfers deemed to be fraudulent or preferential. For instance, section 548 provides for a two year presumption of fraud for transfers of property owned by the debtor.

There are many bankruptcy cases in which courts have disregarded transfers that were ostensibly motivated by estate-planning purposes. In most of these cases, the court's decisions were fact-specific, involving transactions that occurred when the

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fairly increases. Also, there is a much better chance that a settlement will result, especially with a Chapter 7 trustee. The Chapter 7 trustee is a court fiduciary who is required to promptly convert assets and disputes to cash, unlike some litigants who pursue litigation out of principle or some ulterior motive.

creditor claim was known or should have been known by the debtor. One of the critical factors considered by courts is the "timing" of the specific transfers.

Lesson learned: Get your client's estate and income tax plan underway early and document your client's business, estate, tax, family, and other legitimate motives to ensure that a bankruptcy court will not dismantle legitimate planning that occurs before a bankruptcy petition is filed.[19]

Bankruptcy judges often apply substance over form and rely on equitable principles, in rendering decisions, which often favors the trustee and creditors. For example, in *In re Larry Portnoy*,[20] the bankruptcy court ignored the law of the applicable offshore jurisdiction and applied the law of the jurisdiction where the bankruptcy court resided, to determine that offshore trusts were not effective creditor protection devices. In *FTC v. Affordable Media*[21] and in *Lawrence v. Goldberg*,[22] debtors were held in contempt and jailed for not turning over offshore assets. The U.S. Court of Appeals for the Ninth and Eleventh Circuits, respectively, upheld the bankruptcy court's decision in both *Affordable Media* and *Lawrence*.

TIMING CAN BE EVERYTHING

In too many cases, estate and asset protection plans miss key bankruptcy protections or ignore crucial facts that could jeopardize the plan itself. Again the bottom line is that the timing of an asset protection or estate plan is crucial to how it will fare in bankruptcy court.

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19 For bankruptcy cases dealing with estate planning issues, *see In Re Kossow*, 325 B.R. 478 (S.D. Fla. 2005); *In Re Jennings*, 332 B.R. 465 (M.D. Fla. 2005); *In Re Ludwig,* 345 B.R. 310 (Bankr. D. Colo. 2006); *Joseph J. Luzinski v. Peabody & Arnold, LLP and Joel Reinstein, P.A. (In Re Gosman),* Adv. No. 03-3228-BKC-SHF-A (S.D. Fla. 2007).

20 In re Larry Portnoy, 201 B.R. 685 (Bankr. S.D.N.Y. 2996).

21 *Federal Trade Commission v. Affordable Media, LLC, Denyse Lindaalyce Anderson and Michael K. Anderson*, 179 F.3d 1228 (9th Cir. 1999).

22 *Lawrence v. Goldberg* (*In re Lawrence*), 279 F.3d 129 (11th Cir. 2002).

For example, in *In re Agnew*,[23] a farmer owned an undivided 1/5 interest in farmland along with some farming equipment; his mother, in trust, owned the remaining 4/5 undivided interest in the land. The farmer leased the 4/5 parcel from his mother for farming purposes and to live on. Before filing bankruptcy, the farmer transferred his 1/5 interest in the land and his farm equipment to his mother's trust, in exchange for the parcel of land on which he lived. Years before the transfer, the farmer and his mother had discussed making this transfer to ensure that his siblings would not evict him after his mother died.

At issue was whether this transfer should be defeated by Bankruptcy Code Section 522(o)(4), which authorizes the reduction of the amount claimed by a bankruptcy debtor as to homestead property in the amount of any such property that was disposed of in a 10-year period prior to the filing of the bankruptcy petition, if the transfer was made with the intent to hinder, delay, or defraud creditors. Fortunately for the debtor/farmer, the court found there was no intent to defraud creditors; the anticipated bankruptcy filing was not the reason for this transfer even though it was admitted to have been recommended by a bankruptcy consultant shortly before the bankruptcy filing.

In contrast, *In re Lacounte,*[24] the court found that a husband and wife debtor did violate Bankruptcy Code Section 522(o) by selling assets to intentionally divert funds away from creditors. Anticipating bankruptcy, the debtor's daughter sought counsel of an attorney who advised the husband and wife to sell off what they did not need, and use the proceeds to pay down their home mortgage. The Debtors sold 3 family cars and the husband's future interest in his mother's 680 acre farm. They used the proceeds from these sales to pay down the mortgage on their home even though debtors had incurred more than $180,000 in gambling debts on their credit cards. The debtors also transferred the wife's future interest in her mother's home back to her mother because they understood that in bankruptcy proceedings she would most likely lose this family asset to creditors.

[23] *In re Agnew*, 355 B.R. 276 (Bankr. D. Kans. 2006).

[24] *In re* Lacounte, 342 B.R. 809 (Bankr. D. Mont. 2005).

The court held that selling the assets and utilizing the proceeds to pay down the home mortgage was done solely to keep the assets out of reach of creditors. The court found this violated 522(o) and the debtor's homestead exemption was reduced by the amount they received as proceeds from sales of their assets.

Keep in mind that in each of the cited cases, the debtors chose to file voluntarily. In most cases, the debtor may very well be judgment proof and would not have to defend against a creditor with strong-arm powers, such as a trustee. If a debtor has implemented an estate plan with creditor protection features, it is logical to ask, why voluntarily file a bankruptcy?

The point: Often it will be best to "hunker down," live with a judgment and occasional depositions in aid of execution and continually attempt to settle as the years roll on. Keep in mind that as the years roll on, the statutes of limitation continue to click away.

If a planning or asset protection plan is implemented after a demand for payment by a creditor and/or entry of a judgment, a bankruptcy court will be more inclined to find that the plan was a fraudulent transfer.

Planners should advise clients that the risk of a bankruptcy court setting aside or disregarding an asset protection plan increases exponentially based upon the timing of the plan and the existence of a creditor claim. While the burden is on the trustee in bankruptcy to prove that a transfer can be set aside as fraudulent, evidence other than the debtor's testimony, such as communication with third parties, and lack of non creditor planning reasons may be used to determine if sufficient proof exists.

A court evaluating whether sufficient "badges of fraud" exist to demonstrate a fraudulent transfer may consider whether:

1) the transfer is to an insider;
2) the debtor has retained control of the asset;
3) the transfer was concealed;
4) before the transfer, the debtor was sued or demand was made;
5) the transfer was of substantially all of the debtor's assets;
6) the debtor absconded;

7) the debtor removed or concealed assets; and
8) there was no reasonable equivalent value or consideration for the transfer.

Ideally, the Plan should be implemented *before* any creditor claim arises. Many times, the timing of the Plan cannot be controlled, but will be a significant factor.

Under the 2005 Bankruptcy Act, a debtor must maintain a domicile within a certain state for the two years (730 days) prior to filing a petition in order to have that state's exemption laws apply in the bankruptcy.[25] If the debtor's domicile was not located in a single state for that 730-day period, then it is necessary to determine where the debtor resided for the 180 days before those 730 days (days 731 through 910).[26] In those situations the exemption laws of the state where the debtor was domiciled the greatest number of days between day 910 before filing and day 730 before filing will be the state law to apply in the bankruptcy.[27]

Further, as discussed below, a 1,215 day rule applies to qualify a "non-fraudulent transfer into a homestead" for full protection in bankruptcy, even where the state fraudulent transfer rules would not cause a set aside to occur (such as in Florida).[28] A ten-year statute, as described below, will provide for loss of equity in homestead attributable to fraudulent transfers made into the homestead within ten years of filing bankruptcy.

LIMITING RISK:

[25] 11 U.S.C. Section 522(b)(3)(A) (2007).

[26] *Ibid*.

[27] *Ibid*.

[28] Fla. Const. Art. X § 4 providing, in general, that Florida homestead shall be exempt from forced sale; *see* Fla. Stat. § 222.20 excluding the availability of federal exemptions to Florida residents.

As a threshold matter, the first decision is whether to file a voluntary bankruptcy petition. For many clients, there is no need to file a voluntary petition: Their asset protection plan provides enough creditor protection and the non-bankruptcy forum appears to be more debtor-friendly since there are no "strong arm" powers such as the ones provided to a bankruptcy trustee. Outside of bankruptcy, there is no trustee and no strong-arm powers with which to contend.

When an estate planning strategy is put into place; the estate tax, income tax, and financial and family advantages of the arrangement should be emphasized. While important, creditor protection should not be the primary reason of an estate-planning strategy. Rather, estate tax, income tax and other financial considerations should be the motivating factors. For example, if a family were to choose between having an offshore protection trust or a domestic FLP to hold significant long-term assets, the FLP may be more desirable, if discounts for tax purposes, greater control, and expense are important considerations.

On the other hand, offshore asset protection trusts arrangements may be more advantageous when there are significant business reasons for their use. For example, if there are family marital agreements in place in which each spouse agrees to allow premarital assets to be held in offshore trusts. Such agreements may provide to hold such assets in jurisdictions that clearly uphold separate non-marital asset rights, and to resolve any dispute under the law of a jurisdiction that protects such premarital assets. Other examples are longer or eliminated perpetuity statutes, and the ability to use in terrorem clauses.

Also, it is common for non-U.S. clients to want their assets held in a jurisdiction that allows free movement between the country where many of their relatives reside, and the jurisdiction where some portion of their wealth is held. An example would be clients who have relatives that they support or may need to support in the future.

One author has also recently found that many spouses holding significant tenancy by the entireties assets want "contractual assurances" from a surviving spouse that the assets will not be mishandled or lost to a creditor of the surviving spouse. Married couples may choose to execute agreements whereby the surviving spouse

agrees to immediately fund and become co-trustee of a trust established in a "creditor protection trust" jurisdiction.

Clients who have offshore asset protection trust motivation factors, and particularly those who live in states that provide protection for the "cash value" of life insurance policies, also should consider offshore life insurance arrangements that can facilitate holding the underlying policy investments in favorable jurisdictions while offering income tax avoidance under the life insurance provisions of the Internal Revenue Code. Annuity contracts with offshore life insurance companies are also a popular way of attempting to defer income tax on investments that cannot be held under U.S.-sponsored annuities because of insurance commissioner limitations that do not apply in offshore jurisdictions.

The age of the client, tax issues, current stage in life or business and family support factors are all important in fashioning and defending a legitimate plan. At every opportunity, the documents relating to the plan should contain "recitals" or specifically mention the non-creditor protection factors which result in the creation of the plan.

PAPER TRAIL

In defending any estate or asset protection plan, it is important to have a paper trail that justifies the estate-planning purposes behind the transfers. Again, assuming that the timing is in favor of the debtor, documentation that proves adequate and reasonable non-creditor planning purposes for the transfers may provide a bankruptcy judge with sufficient ammunition to defeat efforts by a bankruptcy trustee to enforce a claim against the protected assets. For instance, if a debtor's medical condition is one factor that supports an estate or asset protection plan, it is wise to document the debtor's health and include letters from treating physicians.

LLCS AND FLPS

Limited liability companies (LLCs) and FLPs—integral parts of many estate plans—are popular vehicles to hold valuable family assets. Indeed, typical estate and gift tax planning recognize the advantage of discounting that can occur for gift

tax purposes, and transfer partial interests in an LLC to family members and or trusts for their benefit.

There are some state statutes that limit creditors of a debtor-limited partner. For example, Florida Statute Section 608.433(4) safeguards the membership interest of an LLC owner or member by limiting creditors of a debtor-limited partner to a "charging order." A charging order provides the creditor with the right to receive any distributions that may be paid to the debtor-limited partner, but does not allow the creditor to exercise any rights otherwise held by the limited partner.

A charging order may turn the creditor into a partner for federal tax purposes, although the tax law is not clear on this. The one Revenue Ruling reaching this result involved a situation where the debtor-limited partner voluntarily gave the creditor an assignment of the limited partnership interest. Many authorities believe that a creditor will not be subject to federal income tax by reason of merely holding a charging order.[29] If income is allocated but not distributed, then the creditor has the risk of being taxed on income that is never received.

One suggestion is to make an LLC or limited partnership agreement impose affirmative obligations on members and partners to make future capital calls and to be involved in partnership management. [30] This conclusion is based upon the Bankruptcy Court decision in *Ehmann,*[31] where a bankruptcy judge concluded that charging order protection does not apply once a limited partnership interest is subjected to the Bankruptcy Court's jurisdiction when the debtor-limited partner has filed or has been forced into bankruptcy if the partnership arrangement is non-executory. If executory, a trustee is bound by the operating agreement. LLC and

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812-2nd Tax Mgmt. Est., Gifts & Tr. J. IX.D.2 (2006).

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See Thomas O. Wells & Jordi Guso, *Business Law: Asset Protection Proofing Your Limited Partnership or LLC for the Bankruptcy of a Partner or Member*, 81 Fla. Bar J. 34 (2007).

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This decision was subsequently vacated when the parties settled and the Court approved same. *See Movitz v. Fiesta Investments, LLC*, 337 B.R. 228 (Bank. D. Ariz. 2005).

FLP agreements should state that they are intended to be executory contracts, that is to say, a contract in which obligations exist on both sides that are unperformed:

There is very little case law addressing the question of whether a limited liability company's operating agreements are an executory contract . . . although the Bankruptcy Code does not define the term "executory contract," legislative history and case law cite with approval Professor Vern Countryman's definition: "a contract under which the obligations of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing performance of the other." Vern Countryman, *Executory Contracts in Bankruptcy: Part 1,* 57 Minn.L.Rev. 439, 460 (1973). However, in *In re Warner*, the Bankruptcy Court held that operating agreements do not qualify as an executory contract.[32]

Where a debtor is a limited partner in a limited partnership with no affirmative duties to the partnership, the contract may be considered non-executory, and thus not binding upon the trustee in bankruptcy. On the other hand, if a debtor, as limited partner, has affirmative duties to contribute money and to perform services for the partnership, then the partnership agreement may be considered executory, and may, therefore, receive charging order protection in bankruptcy.

Moreover, LLC members and FLP partners should assume an active role in the management of the entity. Changes to the limited partnership statutes in many states permit participation of limited partners in the management of the entity with loss of limited liability.[33]

Another suggestion made in the article is to include contractual provisions which are authorized by state statute to require the consent of the remaining members when one member seeks to transfer a membership interest.

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[32] 480 B.R. 641 (Bankr. N.D.W. Va. 2012). An article about this case can be found here: http://www.llclawmonitor.com/tags/executory-contract/

[33] *See*, Thomas O. Wells & Jordi Guso, *Business Law: Asset Protection Proofing Your Limited Partnership or LLC for the Bankruptcy of a Partner or Member*, 81 Fla. Bar J. 34 (2007).

Another example of bankruptcy court "interjection" in this area is the case of *In re Ashley Albright*,[34] where a Colorado bankruptcy court held that the trustee in bankruptcy, as the successor of the LLC that had been owned by a debtor, had the ability to provide consent to the transfer of member interest in a single-member LLC, and could therefore exercise management control over the LLC and liquidate the assets of the LLC to realize the value as the sole member. The bankruptcy judge concluded that the purpose of the Colorado charging order statute was to protect other members, even though the language of the statute itself had no mention of the charging order protection only applying in a multiple member situation.

We suggest that an LLC have multiple members, so that if one member ends up in bankruptcy, the presence of other members (hopefully) could strengthen the possibility of applying charging order protection.

Finally, given the discounting that can occur for gift tax measurement purposes, it will often be inconsistent with normal estate and gift tax planning not to transfer partial interests in an LLC to family members and/or trusts for their benefit.

FRAUDULENT TRANSFERS

A fraudulent transfer is defined under the Bankruptcy Code as a transfer that can be avoided by a trustee if the transfer was made with (1) the intent to actually defraud, hinder and delay creditors or (2) in exchange for less than reasonably equivalent value while the debtor was insolvent.[35]

A fraudulent transfer also can be found to have occurred when a debtor has assumed

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34 291 B.R. 538 (Bankr. D. Co. 2003).

35 11 U.S.C. Section 548(a)(1) (2007).

a creditor's obligation instead of making a transfer. If a debtor makes a transfer to a creditor and does not receive equivalent value,[36] a fraudulent transfer exists if

1. the debtor's business (or impending business) held assets unreasonably low in value;

2. the debtor incurred or believed it would incur debts beyond what the debtor could repay; or

3. at the time of the transfer, the debtor was either already insolvent or became insolvent as a result of the transfer.

There is a popular misconception that a "fraudulent transfer" is a transfer that involved defrauding one or more creditors in the bankruptcy court. Under debtor-creditor law, the term "fraudulent transfer" means a transfer made for the purpose of avoiding creditors, or in a situation where the transferor is undercapitalized when business operations and potential risk relating thereto is taken into account. This is certainly different than "committing fraud," which occurs when one party actively misleads another party.

Committing a "fraudulent transfer" in the debtor-creditor law context is generally not a crime, although some states have passed bar rules that prevent lawyers from being integrally involved in helping or advising clients to effectuate fraudulent transfers,[37] even though it may be unconstitutional, and seems at least distasteful by

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[36] Value is defined in 11 U.S.C. Section 548(d)(2)(a) as property, or satisfaction or securing of a present or antecedent debt of the debtor. Thus, a promise to remain employed does not satisfy this definition and is not enough to prevent a fraudulent transfer.

[37] *See, for example*, Connecticut Informal Opinion 91-23-: "A lawyer may not counsel or assist a client to engage in a fraudulent transfer that the lawyer knows is either intended to deceive creditors or that has no substantial purpose other than to delay or burden creditors." The opinion went on to say that the determining factor of impropriety was whether the lawyer knew that the transfer was intended to deceive, embarrass, delay or burden a creditor. *But see* South Carolina Bar Ethics Advisory Opinion 85-02, which specifically held that it was ethical for an attorney to transfer a client's assets to protect against the potential claims of future creditors. There, the Committee held that if there was no immediate reasonable prospect of judgment against the client, to transfers to avoid future creditors was not a violation of the ethics code.

many to prohibit lawyers from advising their clients to take actions that are in the client's best interests. At the least, a client has the right to know all potential actions and potential implications thereof.

A 2012 Florida case involved an attorney who became financially responsible for transfers made to avoid creditors that were processed through his trust account. This case, *Harwell*, establishes that a lawyer may be held liable for disbursing funds in the way a client wishes, if they are being disbursed with the intent to avoid creditors.[38] The bankruptcy trustee tried to recover the funds under 11 U.S.C. § 550(a)(1) claiming the attorney was the initial transferee.[39] Eventually, the bankruptcy court held the attorney was the initial transferee and was liable to the trustee for the funds.

Some transfers that are intended to defeat creditors may be illegal, such as transfers intended to evade collection of taxes by the Internal Revenue Service, under Internal Revenue Code Sections 7206(4) and 7201.[40]

The Florida Supreme Court in the case of *Freeman v. First Union Nat'l Bank*, 329 F.3d 1231 (2003), held that Florida's fraudulent conveyance statute is only a creditor collection tool and is not a basis for damage claims against nontransferees such as third-party financial consultants or legal advisors.

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Harwell Trans. at 24:23-25:4 (M.D. Fla. Nov. 20, 2012). The attorney in question was representing his client in two separate matters, a shareholder dispute and a judgment entered in Colorado. The first matter resulted in the client receiving a substantial settlement from a shareholder dispute action that was to be deposited into an escrow account held by the attorney's firm. The second matter was a judgment entered against the client for over one million dollars. Neither the client nor the attorney revealed to the party which held the million dollar judgment that the client was receiving settlement payments. Instead of satisfying the existing million dollar judgment, the client instructed the lawyer to disburse the funds to third parties which included the client's wife, father, and other various people. The attorney followed the client's instructions with the knowledge that there was this substantial judgment in place.

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Section 550(a)(1) states: (a) Except as otherwise provided in this section, to the extent that a transfer is avoided under section 544, 545, 547, 548, 549, 553(b), or 724(a) of this title, the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from– (1) the initial transferee of such transfer or the entity for whose benefit such transfer was made; (2) any immediate or mediate transferee of such initial transferee

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Fines in the amounts of not more than $100,000 ($500,000 for corporations) and not more than 3 years in prison or both. *See U.S. v. Hook,* 781 F.2d 1166 (6th Cir. 1986), in which the court affirmed appellant's conviction under IRC Section 7201 for concealing assets from the IRS, by forming a corporation to hold stock and automobiles with his wife and daughter as the sole shareholders. He also conducted other transactions not in compliance with the tax code. In dicta, the court also discussed the effect of Section 7206(4) providing that any attempt to conceal assets after a tax assessment, notice and demand of payment, and refusal to pay is a felony under that statute. This case effectively states that some transfers and transactions intended to conceal assets for tax purposes prior to a tax deficiency assessment will be illegal

Any person who 1) conceals a debtor's assets, 2) receives the debtor's assets fraudulently, or 3) transfers or conceals assets on behalf of a corporation intending to defeat the Bankruptcy Code will find himself, and possibly his lawyer, in prison for up to five years.[41] Take for instance *U.S. v. Smithson*,[42] in which the debtor and his lawyer were both convicted and served jail time for a transfer made two days before filing bankruptcy.

Prosecutors also apply 18 U.S.C. Section 371, which prohibits individuals from committing fraud on the United States. The government must prove

1) an agreement between two people,

2) a scheme to defraud the United States, and

3) an overt act committed in furtherance of the agreement.[43]

An attorney was convicted of conspiring to transfer the assets of one corporation to another in contemplation of bankruptcy under both 18 U.S.C. Section 371 and Section 152.[44] There, the attorney counseled the client to transfer some of the corporation's inventory to another company and then auction off the rest of the company's assets. The attorney, Switzer, set up the transactions and prepared confessions of judgment for some favored creditors. The transaction took place prior to the judicial sale for the trustee in bankruptcy's benefit. The Switzer's conviction was upheld on appeal because he was found to have attempted, through

under IRC Section 7201, and that any transfer or concealment of assets after an assessment will be illegal.

41 18 U.S.C. Section 152. Punishment includes fines and/or up to 5 years in prison.

42 49 F.3d 138 (5th Cir. 1995). The case was remanded for re-sentencing.

43 18 U.S.C. Section 371 (2007).

44 *U.S. v. Switzer*, 252 F.2d 139 (2nd Cir. 1958).

his advice and participation in the transactions, to defeat the bankruptcy statutes, and thereby defraud the United States of the client's assets in bankruptcy.

PREFERENTIAL TRANSFERS

While most planners understand state fraudulent transfer rules, which are usually similar to the Bankruptcy Code fraudulent transfer statute, many planners are not conversant with the code's preferential transfer provisions. Transfers made by a debtor to an "insider" within one year of filing a bankruptcy may be set aside, notwithstanding whether the transfer would be considered a "fraudulent transfer" under fraudulent transfer rules.[45] Also, preferential transfers made to any party within one year (if an insider) or 90 days (if not an insider) of the filing of a bankruptcy petition can be set aside as well.[46] Reasonable compensation paid for services actually rendered will not be considered to be a preferential transfer,[47] but dividends paid by a professional practice corporation to its owner or member can be considered a preferential transfer. In addition, repayment of shareholder loans may be set aside as a preference.

A case that deals with this insider creditor issue is *In re Halling*, 449 B.R. 911 (2011). Here, the debtor's son was a guarantor on a loan that was owed by his mother. The mother made regular payments to the bank for this loan, and eventually filed for bankruptcy. The trustee sought to avoid the transfers as preferential, stating that the son was an inside creditor and that transfers made up to one year before bankruptcy were avoidable. The Court stated that guarantors are creditors within the bankruptcy code. The payments to the bank benefitted the son because each payment reduced his liability to the bank. Thus, the Court allowed the trustee to recover the transfer's **from the son** because preference claims against non-insiders (the bank in this case) are limited to transfers within 90 days. Transfers made more than 90 days before the filing of bankruptcy cannot be recouped from creditors who

45 11 U.S.C. Section 547(b)(4)(B) (2007).

46 11 U.S.C. Section 547(b)(4)(A) (2007).

47 *In re Double Eagle Const. Co.,* 188 B.R. 406 (Bankr. D. W. Mo. 1995).

are not insiders in this situation. Thus, for transfers between 90 days and 1 year the trustee can only get transfers to inside creditors (in this case the son).

Transfers can also be illegal if the asset protection planner intends to evade the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration Board's Comptroller of the Currency, or the Director of the Office of Thrift Supervision[48] under 18 U.S.C. Section 1032. In *U.S. v. Brown*,[49] the appellant's conviction for concealing property from the FDIC and the trustee in bankruptcy was affirmed. There, the appellant transferred his interests in a home, fitness center and a corporation to family members and friends. He did not reveal the transfers or his interests to the FDIC, to whom he owed $2.4 million, or to the bankruptcy trustee.

COMPETING CREDITORS

Oftentimes a debtor will want to settle or give a mortgage and/or lien on otherwise exposed assets to a "friendly creditor" to avoid having to lose such assets to one or more other creditors. If the friendly creditor is considered an insider[50], then actions taken that benefit such creditor may be set aside by the other creditors within one year of when they occur. On the other hand, an unrelated friendly creditor (i.e., a creditor who is not an insider) may be able to hold whatever liens or assets it has been given as part of an arms-length debt relief or workout arrangement as long as

48 *810-2nd Tax Mgmt. Est., Gifts & Tr. J.* II.B.1 (2006). Punishment includes fines and/or up to 5 years in prison.

49 1999 U.S. App. Lexis 18225 (10th Cir. 1999).

50 The definition of an insider can be found at 11 U.S.C. section 101(31), which reads as follows: The term "insider" includes (A) if the debtor is an individual - (i) relative of the debtor or of a general partner of the debtor; (ii) partnership in which the debtor is a general partner; (iii) general partner of the debtor; or (iv) corporation of which the debtor is a director, officer, or person in control; (B) if the debtor is a corporation - (i) director of the debtor; (ii) officer of the debtor; (iii) person in control of the debtor; (iv) partnership in which the debtor is a general partner; (v) general partner of the debtor; or (vi) relative of a general partner, director, officer, or person in control of the debtor; (C) if the debtor is a partnership - (i) general partner in the debtor; (ii) relative of a general partner in, general partner of, or person in control of the debtor; (iii) partnership in which the debtor is a general partner; (iv) general partner of the debtor; or (v) person in control of the debtor; (D) if the debtor is a municipality, elected official of the debtor or relative of an elected official of the debtor; (E) affiliate, or insider of an affiliate as if such affiliate were the debtor; and (F) managing agent of the debtor.

the debtor has not filed or been forced into bankruptcy within 90 days of the transfer.

DISTRIBUTIONS FROM "INSOLVENT" ENTITIES

Many accountants advise their clients to "keep wages low and dividends high," but this advice often does not take into consideration fraudulent transfer and preferential transfer rules in the event the client finds himself in a bankruptcy.

Estate and financial planners also need to consider state laws concerning distributions made from a company under circumstances in which sufficient reserves have not been set aside to pay known or expected creditors. The board of directors of a company allowing such distributions can become liable to a creditor. The liability of the directors would be based upon the amount of monies or other assets that should have been left in the company as opposed to being paid out. For example, Florida Statutes Section 607.0640(3), no distributions to shareholders may be made, if after such distribution

(a) the corporation would not be able to pay its debts as they become due in the usual course of business; or

(b) the corporation's total assets would be less than the sum of its total liabilities plus (unless the articles of incorporation permit otherwise) the amount that would be needed, if the corporation were to be dissolved at the time of distribution, to satisfy the preferential rights upon dissolution of shareholders whose preferential rights are superior to those receiving the distribution.

If the distribution falls within the bounds of either of the above definitions, then the distribution is characterized as a wrongful distribution. The director's personal liability is addressed by Florida Statutes Section 607.0834, which places personal liability on any director who votes affirmatively for such a distribution.

The director is personally liable for the amount of the distribution that exceeds what could have been distributed without violating Section 607.06401 or the articles of incorporation if it is established that the director did not perform his or her duties as

required by Section 607.0830 (good faith; reasonable, prudent person standard; in the best interest of the corporation).

Additionally, subsection (2) states that a director held liable under subsection (1) is entitled to contribution from each shareholder for the amount that such shareholder accepted knowing the distribution was made in violation of Section 670.06401.

Further, the director is entitled to contribution from every other director who could be liable under subsection (1) for the unlawful distribution. For example, if there were two director shareholders who split the initial $150,000 distribution, then they could each be held to be jointly and severally responsible for the entire $150,000.

WAGE STATUTE INTERACTION

Some states allow for exemption of wages and even deferred compensation from creditor claims. The 2005 Bankruptcy Act provides that a Trustee may void a transfer of property or an obligation (including any "transfer to or for the benefit of an insider under an Employment Agreement") if made within two years before filing, as a fraudulent conveyance or a preferential transfer for less than adequate consideration.

It is therefore important to be able to document that any compensation was actually owed when wages are paid to related parties or "insiders" if a company may become insolvent.

10 YEAR RULE FOR ASSET PROTECTION TRUSTS SIMILAR ARRANGEMENTS

Asset protection trusts are arrangements whereby creditors of a beneficiary may not have access to trust assets, based on the law of the jurisdiction where the trust is formed and operated. Asset protection trust jurisdictions in the United States and abroad have proliferated.

The 2005 Bankruptcy Act makes transfers to self-settled trusts or similar devices subject to being set aside in bankruptcy when made within 10 years of filing. A self-settled trust is a trust established by an individual that allows for the trust assets

to be held for the possible benefit of that individual. This 10-year set aside statute applies if the transfer was made with the "actual intent" to hinder, delay or defraud present or future creditors.[51]

The 10-year rule should not apply if the debtor forms an offshore trust for the benefit of the debtor's family, and not for the debtor himself. "Substantial de facto control," however, has been found to be sufficient for a court to find that the trust should be disregarded for creditor protection purposes.[52]

New Bankruptcy Code Section 548(e)(1) applies to both domestic and offshore asset protection trusts. Time will tell whether asset protection trusts that have been funded for more than 10 years before the filing of bankruptcy will be better respected than they have been in the past by bankruptcy courts.

As discussed above, several bankruptcy court decisions have concluded that offshore asset protection trusts are either invalid, or that the debtors involved with offshore asset protection trusts can be jailed on contempt.[53]

Nevertheless, informal reports of favorable settlements reached by debtors whose creditors would apparently prefer not to "go the distance" to obtain offshore trust assets have been reported. Further, there is no case known to the authors where the assets of an offshore asset protection trust have been involuntarily obtained by a creditor.

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[51] 11 U.S.C. Section 548(a)(1) (2007).

[52] *See* Steve Leimberg's Asset Protection Planning Newsletter # 70 (Sept. 12, 2005) at www.leimbergservices.com, which discusses *Federal Trade Commission v. Ameridebt*, 373 F. Supp.2d 558 (D. Md. 2005) in which the debtor, under FTC investigation, transferred nearly $24 million to offshore trusts and used other money to pay for lavish expenses.

[53] For more information on asset protection see Barry S. Engel's *Asset Protection Planning Guide (3rd edition).*

ANNUITIES AND LIFE INSURANCE

Some states offer unlimited protection of life insurance and the cash values of annuity contracts. Some states only protect certain financial products if and to the extent that they are reasonably necessary for the support and/or retirement of a debtor. The life insurance, annuity, and offshore financial service industries have come to market with mutual fund wrapped products that provide income tax deferral and creditor protection for policyholders and their families.

Is an annuity a "similar device" that would not be protected in bankruptcy under the provision applying to asset protection trusts, where within 10 years of filing, a transfer is made into an annuity or life insurance product with the actual intent to hinder, delay or defraud present or future creditors?

The only case that has considered this question is *In re Portco*, which is a March 30, 2011 Bankruptcy Court decision that held that Congress only intended to capture "a similar device" [to an asset protection trust] that had the same effects as a self-settled trust, and that only an express trust was within that definition." The court stated that the purpose of the Bankruptcy Code Section 458(c) was to thwart the protection of "domestic asset protection trust jurisdiction." In this case a debtor company was entitled to receive real estate from a third party by contract, and instead allowed the real estate to go to a separate company owned by the same shareholder.[54]

At one point in the legislative process this asset protection trust 10-year set aside provision was to specifically exclude qualified retirement plans. Does this mean that the legislative intent was to specifically include many financial products that would be similar to qualified retirement plans, such as annuities? Is the language "self-settled trust or similar device" broad enough to include annuity and life insurance arrangements where money is given to a life insurance company that invests it and makes cash available at a later time, subject to state or foreign jurisdiction creditor protection laws and arrangements?[55]

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[54] 447 BR 590 (Bankr.S.D.Ill 2011).

[55] *See* 11 U.S.C. Section 548(e) (2007); *See also* Alan S. Gassman, Steven Holub, and Jeffrey M. Gad, Steve

HOMESTEAD EXEMPTION

The "mansion loophole closing" provisions of the 2005 Bankruptcy Act will reduce the protected homestead equity value to as low as $155,675 if one of three exception provisions applies:

(1) The entire value of homestead property will not be protected where its value has been increased by a disposition of non-exempt property made by the debtor during the 10 years prior to filing bankruptcy with the intent of hindering, delaying, or defrauding creditors. [56]

The reduction is based upon the value of the homestead resulting from such "fraudulent transfers." The courts must determine how to apportion appreciation in the value of a homestead that occurs after the "fraudulent conversion" has occurred.

(2) A debtor cannot exempt any amount of homestead property worth in excess of $155,675 that is acquired during the 1,215 days (three years and four months) before the bankruptcy filing.[57]

This was originally $125,000, but under the legislation adjusted to $155,675 on April 1, 2010, and will adjust with the Consumer Price Index each three years thereafter pursuant to U.S.C. Section 104(b).

This is not an intent-based provision, but applies automatically when a person does not have the requisite time period to qualify for protection.

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56 Leimberg's Estate Planning Newsletter, No. 485.
11 U.S.C. Section 522(o) (2007).

57 11 U.S.C. Section 522(p) (2007); *but see* Steve Leimberg's Employee Benefits and Retirement Planning Newsletter #75 (Dec. 9, 2005) at *www.leimbergservices.com* which discussed *In re Blair*, No. 05-35922-HDH-7 (Bankr. Ct. N.D. Texas) in which an increase in the value of a debtor's homestead (increase of value of over $136,875 in 12 day period) was not subject to the $136,875 cap; however, the article cautioned that *irregular* payments of a mortgage may not be disregarded.

As an exception to this $155,675 cap, money derived from the sale of a prior residence can be applied to facilitate the purchase of a replacement property if certain requirements are met. Where the new homestead costs significantly more than the prior homestead, the amount of homestead protection is limited to $155,675 plus the proceeds from the sale of the prior residence used to purchase the new residence.

Several issues will arise with respect to how to handle appreciation, depreciation, and amortization of mortgage indebtedness in the context of successor homes.

In a post-BAPCPA case decided in October of 2005, *In re Charles H. Wayrynen,* a debtor who had not lived in Florida 1,215 days filed bankruptcy with a homestead and was found not to be subject to the $136,875 cap.[58] The court found that the statute would only apply where the debtor elects to use state exemptions, and Floridians are *required* to use the state exemptions, and have no elective choice between the federal and state exemptions.

Whoever drafted the statute must have assumed that all debtors have the opportunity to elect to use the federal exemptions or the state exemptions, not realizing that in Florida the debtors are required to use the state exemptions. Congress' obvious intent was to limit the Homestead Exemption to $155,675 for debtors who choose to flee to debtor-friendly Homestead Exemption states, the most notable being Florida and Texas, unless the debtor resides in the Homestead protection state for at least 1,215 days before filing.[59]

At least three courts have found that the clear intent of the statue overrides the literal reading, and have enforced the 1,215-day rule in states, such as Florida and

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In re Charles H. Wayrynen, 2005 WL 2756059 (Bankr. S.D. Fla. 2005).

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Some states may offer unlimited protection like Florida, Texas, Kansas and Iowa while other states provide protection well below the federal limit like Arkansas, which only offers $2,500 as a state homestead exemption protection.

Nevada, that allow debtor's to "opt out" of the federal exemptions in favor of using the state exemptions.[60]

(3) The homestead exemption can be limited to an absolute cap of $155,675 where the debtor is convicted of a felony, which evidences that the filing of the bankruptcy was abusive (perhaps the rationale here is that the debtor will not need a house if he is going to jail).[61]

The homestead protection is limited to $155,675 where the debt involved arises from the violation of federal or state securities laws, fiduciary fraud violations of RICO, intentional torts or willful or reckless conduct resulting in serious physical injury or death in the preceding five years.[62] Doubtlessly, there will be more suits filed against doctors alleging willful and reckless conduct in malpractice actions.

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See Steve Leimberg's Asset Protection Planning Newsletter # 74 (Nov. 17, 2005) at *www.leimbergservices.com* which discussed *In re Virissimo and In re Heisel*, Chapter 7, Case Nos. BK-s-13605-LBR and BK-S-05-15667-LBR, a decision by U.S. Bankruptcy Judge Linda B. Riegle which resolved both *In re Robert* and *Virissimo* and *In re Cheryl Heisel.* The court applied the federal $136,875 cap to debtors in Nevada which provides a $200,000 cap on homestead and $350,000 effective July 1, 2005; *see also In re Kaplan,* 331 B.R. 483 (S.D. Fla. 2005) which applied the federal $136,875 to a Florida (a state that requires state exemptions and does not allow debtors to choose between state or federal exemptions) debtor and stated, "[d]etermining whether the homestead caps apply in Florida should not be in dispute and should not distract us further. This Court sincerely hopes that there will be uniformity amongst the Florida judges in finding, as this Court does with certainty, that the limitations in Bankruptcy Code Section 522(p) and (q) apply to debtors claiming exemptions under Florida law."

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11 U.S.C. Section 522(q) (2010).

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11 U.S.C. Section 522(q)(1) (2010).

The Section 522(q)(1) reduction to $155,675 will not apply to the extent that the homestead property is reasonably necessary for the support of the debtor and any dependant of the debtor.[63] How much of a home will debtors be found to need?

a. Two spouses enjoy the benefit of two caps? In *In re Rasmussen*,[64] 349 B.R. 747 (M.D. Fla. 2006), the Bankruptcy court in the Middle District of Florida ruled that two spouses could stack their state law homestead exemptions together creating $250,000 of coverage for their home. The court cited Section 522(m) which applies Section 522 separately to individuals filing joint bankruptcy cases. The court went on to analogize the homestead exemption to other exemptions married bankrupt's may file together such as $2,000 total for automobile exemptions and $2,000 total for personal property exemptions.

b. The homestead of a married debtor residing in a tenants by the entireties state may be protected if the homestead is owned as tenants by the entireties, thus, circumventing the exceptions to homestead protection described above.

c. The home to be protected does not appear to be required to be actually occupied as a *principal* residence for the 1,215 days.[65] Many individuals will therefore be advised to acquire a second home in a homestead protective state such as Florida or Texas to start the 1,215-day period, and then to move to such state 730 days before filing a bankruptcy.

d. A debtor can lose his or her house if he or she loses the discharge. Paying one's mortgage down with non-exempt monies can be detrimental where the payment causes the debtor to lose his bankruptcy discharge. In the case of *In re Chauncey*, a pre-BAPCPA case, the United States District Court affirmed

63 11 U.S.C. Section 522(q)(2) (2010).

64 349 B.R. 747 (M.D. Fla. 2006).

65 11 U.S.C. Section 522(p) (2007).

the Bankruptcy Court opinion where the debtor went bankrupt within one year from having a personal injury settlement─applied to pay down her mortgage.[66]

Because the personal injury settlement was non-exempt money, the Bankruptcy Court denied the discharge. Moreover, the Bankruptcy Court imposed an equitable lien upon Mrs. Chauncey's home in order to allow the creditor to recover the monies that were secreted into the home from the personal injury settlement.

e. Fear and loathing in Florida – A married physician owing a joint mortgaged house and individual exposed assets meets a potential judgment creditor. Assume that a married physician has cash or similar liquid assets exposed to creditor claims *and* a serious malpractice action against her.

The Florida Supreme Court has held that a fraudulent transfer into a homestead owned by her would not be susceptible to the Florida Fraudulent Transfer Statute.[67] This means that a creditor would not be able to force her to sell the home if it is her legitimate homestead when the creditor attempts to collect upon a judgment.

A "transfer into a homestead" can include buying a new home, paying to improve a home, or paying down a mortgage on a home.[68]

The creditor might attempt to force the doctor into bankruptcy. If the doctor has 12 legitimate creditors, which could include "material" credit card debts and/or other individual (including joint) indebtedness, then it would take three creditors to force her into bankruptcy. One issue is if the doctor is not

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66 *In re Chauncey*, 2005 WL 2456223 (S.D. Fla. 2005).

67 *Havoco of America, LTD. v. Hill*, 790 So.2d 1018 (Fla. 2001).

68 Fla. Stat. Section 193.155(4) (2007).

eligible to file then can the involuntary petition stick? [69] For instance, a possible argument is that in order to qualify as a debtor, the debtor must pass a "means test". If the debtor is not eligible, then the involuntary petition should be dismissed.

If the doctor is forced into bankruptcy with her "fraudulently acquired" home, then under the Bankruptcy Code she loses the homestead protection (exemption) to the extent of the value of the homestead attributable to such fraudulent transfers[70] (but there will be at least $155,675 of protection notwithstanding).[71]

The transfer into the homestead may not actually be a fraudulent transfer under the Bankruptcy Code. For example, if the doctor buys the home because she wants to have a larger home for her family, and at the time she buys the house it is the opinion of reputable legal counsel that the lawsuit is nothing to worry about because she has enough malpractice insurance or other assets set aside to cover any likely potential verdict, then the creditor may not be able to satisfy its burden of showing that the homestead transfer was subject to the fraudulent transfer rules.

How about if the doctor transfers her cash into a jointly owned homestead, either by simply purchasing a joint homestead, or improving or paying down the mortgage on a jointly owned homestead.

Using this approach, the doctor could later file bankruptcy and would not have to "take the homestead exemption" in bankruptcy because her Florida jointly owned property can qualify under the "tenancy by the entireties" exception. Therefore, the

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69 *See* 11 U.S.C. Section 303(b)(2) (2007) indicating that a debtor must have at least 12 legitimate creditors before filing a voluntary petition.

70 Fla. Stat. Section 222.29 (2007).

71 11 U.S.C. Section 522(p) (2007).

bankruptcy code 10-year look back for fraudulent transfers into a homestead would not apply, because the exemption in bankruptcy would be based upon tenancy by the entireties, and not homestead.

A possible problem here is that the transfer of monies by the debtor into a *joint homestead* could be considered a fraudulent transfer of one half of those monies to the husband under the BAPCPA. While the Florida Fraudulent Transfer Rules are trumped by the state law homestead exemption, if the doctor is forced into bankruptcy it is possible that the Bankruptcy Court's ability to pursue the "transferee of a fraudulent transfer" could result in the husband being pursued for one-half (½) of the amounts transferred.

If the husband has no other significant assets, then this may not be a problem. Even if there is a judgment against the husband for having received a fraudulent transfer, the creditor will not be able to attach the husband's homestead under Florida law, unless the husband could then be forced into bankruptcy and then be subject to the 10-year look back rule. If the husband has other assets that would be subject to creditor claims in bankruptcy, then this alternative of transferring assets into a joint homestead, as opposed to moving such assets into a solely held homestead, may not be advantageous.

What about if the doctor uses her money to buy out her husband's half of the homestead? If the wife has $500,000 in cash and the jointly owned home has $1,000,000 in equity, she can transfer the $500,000 in cash to her husband in exchange for 100% ownership of the home. In effect she has purchased the husband's ownership in the home.

The question becomes whether the husband has then received $500,000 as a fraudulent transfer that could be set aside under the fraudulent transfer rules?

When the debtor (doctor) has transferred assets as "good and valuable consideration" in exchange for 100% ownership in a homestead, then the creditor is going to have a more difficult burden to satisfy, because under the fraudulent transfer rules a "fraudulent transfer" made for "adequate consideration" can only be set aside if it can be proven that the transfer was made with actual intent to hinder, delay, or defraud" a creditor.[72]

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[72] Fla. Stat. Section 726.105(1) (2007). *See also* Fla. Stat. Section 726.105(2) and the Bankruptcy Code for factors used in determining whether there exists actual intent to hinder, delay, or defraud with respect to fraudulent transfers which include the following: (a) whether the transfer was to an insider, (b) whether the debtor retained control

If a transfer is not made for valuable consideration, then the creditors have a lower burden in establishing that the "fraudulent transfer statute" applies. Under such circumstances (where there is not adequate consideration for the transfer) the fraudulent transfer statutes allow for the transfer to be set aside under circumstances defined in the statute.[73]

Thus, if a physician senses impending insolvency she may be wise to buy her spouse's half of the homestead property and have him hold the cash in a separate account, portfolio, or other liquid form. If the transfer is deemed "fraudulent" the spouse can return the money to the doctor's creditor without penalty, none-the-worse for having tried. If the transfer is not deemed "fraudulent" the physician has in effect saved a substantial asset by keeping it in the family.

Another situation to consider is where the creditor, knowing that he or she may be going into bankruptcy, gives the monies to a close friend who puts them into a homestead and then intends to hunker down and remain judgment proof, and outside of bankruptcy, so that the creditor is not able to recover the funds, and the debtor is able to live with the close friend and enjoy the benefit of the home. Will this boat float? This exact fact pattern occurred in In re Bifani, 493 B.R. 866, 871 (Bankr. M.D. Fla. 2013) where the debtor transferred property to his significant other before filing bankruptcy. The significant other sold the property and used the proceeds to purchase a homestead for herself in Florida. The court held that a fraudulent transfer, directly or indirectly, to the debtor's cohabiting and apparent significant other before filing bankruptcy rose to the level of being considered a secretion of "ill-gotten gains" under Florida law, which would have otherwise not permitted any creditor to pursue the property, stating specifically that:

> Here, LaMarca's Sarasota house was acquired with ill-gotten proceeds. LaMarca used the nearly $670,000 from the sale of the Golden Eagle

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over the transferred property, (c) whether the transfer was concealed, (d) whether the debtor was involved or threatened by a suit prior to, or at the time of, the transfer, (e) how much of the debtor's assets were transferred, (f) whether the debtor absconded, (g) whether the debtor concealed assets, (h) the value of the property received in exchange for the property transferred, (I) Whether the debtor was insolvent at the time of, or shortly after the transfer, (j) the timing of the transfer in relation to the incurrence of a substantial debt by the debtor, and (k) whether the debtor transferred essential business assets to a lienor, who then transferred the assets to an insider.

[73] *See* 11 U.S.C. Section 548(a)(1) (2007).

> Road property to purchase her Sarasota house. It would be inequitable and unjust to allow the Debtor [Bifani] to fraudulently transfer property to LaMarca to keep it from his creditors.[74]

This decision was overturned by the Federal Court in Tampa, but then upheld by the Eleventh Circuit Court of Appeal, which indicated as follows:

> Under Florida law, homestead property purchased with funds obtained by fraud is not exempted from equitable liens. See Havoco, 790 So.2d at 1028. The facts of this case do not fall within Havoco's exception because the funds used to purchase the Sarasota property were obtained through Bifani's fraudulent transfers….That the fraud occurred in a bankruptcy proceeding rather than a criminal offense is irrelevant.[75]

CONCLUSION

Bottom line: Estate planners giving asset protection advice need to help make their client aware of the many pitfalls that can exist in the world of bankruptcy. We recommend consultation with a bankruptcy lawyer before undertaking planning steps that may someday be criticized by a bankruptcy judge and/or litigation counsel.

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74 In re Bifani, 493 B.R. 866, 871 (Bankr. M.D. Fla. 2013).

75 In re Bifani, 580 F. Appx. 740, 747 (11th Cir. 2014).