Prudent Planning or Fraudulent Transfer? The Use of Nonexempt Assets to Purchase or Improve Exempt Property on the Eve of Bankruptcy

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The debt collection process in Anglo-American law is based on the creditor's right to receive payment from liquidation of the debtor's assets. Judicial procedures are available to the unsecured creditor for the purpose of converting the debtor's assets to cash. Whenever the debtor's matured liabilities are greater than his assets, the collection process may be characterized as one of "grab law" in which the first creditors to take the debtor's assets succeed in effectuating collection.¹

It is an economic necessity for creditors to have an efficient collection mechanism which gives them maximum protection in the event of default by the debtor.² Nonetheless, all states shield the debtor from complete destitution by keeping certain property, for example, life insurance proceeds, beyond the reach of creditors.³ By permitting the debtor to keep those assets necessary for his economic survival, state exemption laws fulfill important social policies which must be balanced against the need for creditor protection.


² The National Commission on Consumer Finance studied and appraised the functioning and structure of the consumer finance industry. The Commission's report contained the following observation:

"[C]ommercial society's dependence upon credit necessitates the enforcement of borrower's obligations. Any freedom of assets from legal seizure reduces the moral and legal duty to repay, thereby adding to the creditor's risk of loss and retarding lending." Note, Bankruptcy Exemptions: Critique and Suggestions, 68 YALE L.J. 1459 (1959).

When a debtor files a petition in bankruptcy, the bankruptcy trustee takes title to most of the debtor's property, thereby enabling the trustee to liquidate the debtor's assets for the benefit of creditors. The twofold purpose of federal bankruptcy law is to give the debtor a fresh start by discharging his debts and to make an efficient, fair, and equitable distribution of the debtor's assets among his creditors. By recognizing exemptions, both the Bankruptcy Act now in effect and the Bankruptcy Reform Act of 1978 permit the debtor to keep those assets needed for a fresh start while protecting the rights of creditors with respect to the debtor's nonexempt property.

A debtor who faces bankruptcy is naturally tempted to salvage as much of his property as possible to protect himself and his family. In order to maximize the benefits available under exemption statutes, such a debtor might purchase or improve exempt property on the eve of bankruptcy.

4. Section 70(a) of the Bankruptcy Act provides that the trustee in bankruptcy shall be "vested by operation of law with the title of the bankrupt as of the date of the filing of the petition initiating a proceeding under this title, except insofar as it is to property which is held to be exempt..." 11 U.S.C. § 110 (1970). See, e.g., MACLACHLAN, supra note 1, at 167-94; 2 D. COWANS, BANKRUPTCY LAW AND PRACTICE § 604 (2d ed. 1978).

Similarly, the Bankruptcy Reform Act of 1978, which will govern bankruptcy cases commencing on or after October 1, 1979, provides for creation of a bankruptcy estate to be liquidated by the trustee. Bankruptcy Reform Act, Pub. L. No. 95-598, §§ 541, 704(1), 92 Stat. 2549 (to be codified in 11 U.S.C. §§ 541, 704(1) (effective Oct. 1, 1979).

5. The United States Supreme Court described the purpose for the debtor as follows:

One of the primary purposes of the Bankruptcy Act is to "relieve the honest debtor from the weight of oppressive indebtedness and permit him to start afresh free from the obligations and responsibilities consequent upon business misfortunes"... This purpose of the act has been again and again emphasized by the courts as being of public as well as private interest, in that it gives to the honest but unfortunate debtor who surrenders for distribution the property which he owns at the time of bankruptcy, a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of pre-existing debt.


6. See notes 9, 17, 18 and accompanying text infra.

7. On November 6, 1978, the President signed into law the Bankruptcy Reform Act of 1978. The Reform Act, which will govern bankruptcy cases commencing on or after October 1, 1979, repeals the present Bankruptcy Act and replaces it. Bankruptcy Reform Act, Pub. L. No. 95-598, § 401(a), 92 Stat. 2549 (to be codified in 11 U.S.C. § 401(a)). The Bankruptcy Reform Act is the first major revision of the federal bankruptcy laws in forty years. See Trost & King, Congress and Bankruptcy Reform Circa 1977, 33 BUS. LAW. 489 (1978).

8. When discussing both collection of the estate and discharge, one should be aware that the debtor and his creditors are engaged in what could be described as a great game. The goal of the game for the debtor is to retain as much property as possible despite the bankruptcy proceeding. The exemption provisions of state and federal law are the most plainly relevant tools for achieving this goal.

This article will address the question of whether an insolvent debtor should be permitted to use nonexempt assets to acquire or improve exempt property in contemplation of bankruptcy. The legal ramifications of such an acquisition or improvement under present law and the ethical problems for lawyers who counsel debtors will be examined and their judicial treatment criticized. Finally, because the Bankruptcy Reform Act continues to allow debtors the benefit of exemptions, yet fails to address the problem of converting nonexempt property to exempt property prior to bankruptcy, recommendations for further legislative reform will be set forth. These reforms would permit and even encourage the purchase or improvement of exempt property on the eve of bankruptcy.

I. INTERACTION OF STATE AND FEDERAL BANKRUPTCY LAWS

The present Bankruptcy Act does not contain specific exemptions for debtors. Instead, it recognizes state and federal nonbankruptcy exemption statutes. Exemptions granted under present federal


See Holden v. Stratton, 198 U.S. 202, 213-14 (1905) ("[i]t has always been the policy of Congress both in general legislation and in bankrupt acts, to recognize and give effect to the state exemption laws").


Although state law determines what property is exempt under present law, federal bankruptcy rules control the procedures for claiming and allowing exemptions. See Bankruptcy Act § 7(a)(8), 11 U.S.C. § 25(a)(6) (1970); FED. R. BANKRUPTCY PROC. 403. The United States Supreme Court has held that the bankruptcy court's jurisdiction over exempt assets is limited to the determination of the exemption's validity. Once the court determines that the property is exempt under state law, creditors seeking to avoid the exemption, either on the ground that the exemption was waived or otherwise, must seek relief in state court. Lockwood v. Exchange Bank, 190 U.S. 294 (1903). See In re Jackson, 472 F.2d 589, 590 (9th Cir. 1973); Williams v. Wirt, 423 F.2d 761 (5th Cir. 1970); 68 YALE L.J., supra note 2, at 1476; 35 U. PIT. L. REV., supra note 5, at 634-35; Kennedy, Limitations of Exemptions in Bankruptcy, 45 IOWA L. REV. 445, 462-69 (1960). Under the Bankruptcy Reform Act, however, the exempt property will become part of the bankruptcy estate, thereby bringing it within the court's jurisdiction. Creditors claiming that the exemption has been waived or is otherwise invalid will have to litigate...
legislation, however, are very limited in scope and do not benefit the majority of debtors.10 Most federal exemptions relate to monetary benefits and pensions, including payments made under the Foreign Service Retirement and Disability System,11 the Social Security Act,12 and the Longshoreman's and Harbor Workers' Compensation Act;13 benefits from the Veterans Administration14 and Railroad Unemployment Insurance;15 and retirement pensions for civil service employees of the United States.16 These exemptions cannot be readily acquired or increased in contemplation of bankruptcy absent an event outside the debtor's control. State exemption laws have a much larger role in bankruptcy cases under present bankruptcy law and are more useful to most debtors.

The Bankruptcy Reform Act of 1978 changes present law by giving debtors who file bankruptcy petitions on or after October 1, 1979, a choice between two exemption systems. The debtor will be allowed to elect either the exemptions permitted by the laws of the state of his domicile and by federal nonbankruptcy law, or he may choose those exemptions set forth in the Bankruptcy Reform Act.17 Any
(1) The debtor's aggregate interest, not to exceed $7,500 in value, in real property or personal property that the debtor or a dependent of the debtor uses as a residence, in a cooperative that owns property that the debtor or a dependent of the debtor uses as a residence, or in a burial plot for the debtor or a dependent of the debtor.

(2) The debtor's interest, not to exceed $1,200 in value, in one motor vehicle.

(3) The debtor's interest, not to exceed $200 in value in any particular item, in household furnishings, household goods, wearing apparel, appliances, books, animals, crops, or musical instruments, that are held primarily for the personal, family, or household use of the debtor or a dependent of the debtor.

(5) The debtor's aggregate interest, not to exceed in value $400 plus any unused amount of the exemption provided under paragraph (1) of this subsection, in any property.

(6) The debtor's aggregate interest, not to exceed $750 in value, in any implements, professional books, or tools, of the trade of the debtor or the trade of a dependent of the debtor.

(7) Any unmatured life insurance contract owned by the debtor, other than a credit life insurance contract.

(8) The debtor's aggregate interest, not to exceed in value $4,000 less any amount of property of the estate transferred in the manner specified in section 542(d) of this title, in any accrued dividend or interest under, or loan value of, any unmatured life insurance contract owned by the debtor under which the insured is the debtor or an individual of whom the debtor is a dependent.

(9) Professionally prescribed health aids for the debtor or a dependent of the debtor.

(10) The debtor's right to receive—

(A) a social security benefit, unemployment compensation, or a local public assistance benefit;

(B) a veteran's benefit;

(C) a disability, illness, or unemployment benefit;

(D) alimony, support, or separate maintenance, to the extent reasonably necessary for the support of the debtor and any dependent of the debtor;

(E) a payment under a stock bonus, pension, profitsharing, annuity, or similar plan or contract on account of illness, disability, death, age, or length of service, to the extent reasonably necessary for the support of the debtor and any dependent of the debtor, unless—

(i) such plan or contract was established by or under the auspices of an insider that employed the debtor at the time the debtor's rights under such plan or contract arose;

(ii) such payment is on account of age or length of service; and

(iii) such plan or contract does not qualify under section 401(a), 403(a), 403(b), 408, or 409 of the Internal Revenue Code of 1954 (26 U.S.C. 401(a), 403(a), 403(b), 408, or 409).

(11) The debtor's right to receive, or property that is traceable to—

(A) an award under a crime victim's reparation law;

(B) a payment on account of the wrongful death of an individual of whom the debtor was a dependent, to the extent reasonably necessary for the support of the debtor and any dependent of the debtor;

(C) a payment under a life insurance contract that insured the life of an individual of whom the debtor was a dependent on the date of such individual's death, to the extent reasonably necessary for the support of the debtor and any dependent of the debtor;

(D) a payment, not to exceed $7,500, on account of personal bodily injury, not including pain and suffering or compensation for actual pecuniary loss, of the debtor or an individual of whom the debtor is a dependent; or

(E) a payment in compensation of loss of future earnings of the debtor or an individual of whom the debtor is or was a dependent, to the extent reasonably necessary for the support of the debtor and any dependent of the debtor.

state may, however, prevent its debtors from choosing the newly created federal Bankruptcy Act exemptions by passing legislation that specifically prohibits such an election.\textsuperscript{18} As a result, unless the state legislature provides otherwise, the Bankruptcy Reform Act establishes a minimum exemption level to protect debtors domiciled in those states that have less generous exemption statutes. State exemption laws, however, will continue to play an important role in states that have more favorable exemptions than those contained in the new Act or in states that enact legislation prohibiting the use of federal bankruptcy exemptions.

II. ORIGIN AND DEVELOPMENT OF EXEMPTION LAWS

Various historical factors influenced the adoption of state exemption laws in the United States.\textsuperscript{19} Many of the northeastern states adopted restrictive exemptions similar to those then in effect in England.\textsuperscript{20} The English laws, based on the notion of affording all debtors a degree of human dignity and decency, were limited to such necessities for survival as clothing, bedding, and tools of trade.\textsuperscript{21} Economic depressions in the United States during the eighteenth and nineteenth centuries, however, demonstrated that anyone could be economically victimized by fortuitous events. As a result, legislators became willing to grant more generous exemptions to protect debtors from poverty.\textsuperscript{22} More liberal exemption laws were passed in response to


\textsuperscript{19} History and local traditions are factors which contributed to the lack of uniformity among state exemption laws. See 53 CORNELL L. REV., supra note 9, at 668. Several state exemptions are constitutionally mandated. See e.g., ALA. CONST. art. 10, § 205; FLA. CONST. art. 10, § 4(a)(1); OKLA. CONST. art. 12, § 1; TEX. CONST. art. 16, § 51. Most exemption laws, however, are statutory. See, e.g., CAL. CIV. CODE § 1241 (West Supp. 1973); MINN. STAT. ANN. § 510 (1947); N.Y. CIV. PRAC. LAW § 5205 (McKinney 1963 & Supp. 1973).

\textsuperscript{20} For a discussion of the influence of English law on early colonies in the United States, see generally Reisenfeld, Law-making and Legislative Precedent in American Legal History, 33 MINN. L. REV. 103, 107-15 (1949).

Exemption laws in northeastern states may also reflect traditional pro-commerce attitudes, as well as early puritanical attitudes toward thrift and economic responsibility. See Vukowich, supra note 3, at 782 n.15; 68 YALE L.J., supra note 2, at 1465.

\textsuperscript{21} To avoid breaches of the peace, English common law allowed the debtor to keep his clothing. As against the landlord's remedy of distress for rent, the debtor was allowed to keep only those tools, utensils, and animals that he used to earn a living, in order to enable him to produce income with which to pay his debts. In 1845, England adopted its first exemption statute, which extended only to wearing apparel, bedding, and tools of trade not exceeding a total value of £5. Small Debts Act, 8 & 9 Vict., c. 127, § 8 (1845). See Bombauer, Debtors' Exemption Statutes—Revision Ideas, 36 WASH. L. REV. 484, 485 n.5 (1961); Vukowich, supra note 3, at 782. For a comparison of modern English and American exemption laws, see Joslin, Bankruptcy: Anglo-American Contrasts, 29 MODERN L. REV. 149, 154-58 (1966).

Early English bankruptcy policy reflected a policy of deterrence which was harsher in nature than modern bankruptcy laws and "not far removed from the criminal nature." Joslin, supra, at 152.

\textsuperscript{22} See Vukowich, supra note 3, at 783. As a result of the depression of 1837, several states adopted homestead exemptions. See 68 YALE L.J., supra note 2, at 1463.
widespread impoverishment following the Civil War. In some western and southern states, liberal exemption laws were enacted to attract settlers who were permitted to keep their homesteads and other property free from creditors' claims. It has also been suggested that generous exemption laws resulted from hostility in rural areas toward creditors who were concentrated in urban centers.

In addition to historical forces, lobbying efforts by various interest groups undoubtedly had an impact on state exemption laws. It is difficult to ascertain any other reason for states to have exempted shares of stock in building and loan associations or cash deposits in savings and loan associations, without exempting other types of stock or cash deposit accounts in other financial institutions.

These historical and political influences resulted in wide disparity among exemption laws from state to state and region to region. These factors also make it difficult to generalize about the original legislative purposes underlying particular exemption laws. Nonetheless, in order to deal with the question whether a debtor should be permitted to purchase exempt property in contemplation of bankruptcy, it is necessary to identify the justifications, if any, for maintaining exemption laws in modern society.

Current state and federal exemption laws promote five distinct social policies. Each specific exemption should further one or more of the following policies:

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

23. See C. Warren, Bankruptcy in United States History 149 (1972); 68 Yale L.J., supra note 2, at 1464.
25. See Vukowich, supra note 3, at 783.
29. See D. Stanley & M. Girth, Bankruptcy: Problem, Process, Reform 82 (1971); Kennedy, supra note 9, at 447 ("The variety of legislation encountered in American jurisdictions almost defies classification."); 68 Yale L.J., supra note 2, at 1463-65.
A. Providing the Debtor with Property Needed for Survival

Providing the debtor with assets needed for basic survival is an important purpose of debtor exemption laws.30 The most common exemptions which serve this purpose are those for food,31 clothing,32 and household furniture.33 Some states identify very specifically the household items which a debtor may keep free of creditor's claims. These items include beds,34 television sets,35 radios,36 stoves,37 refrigerators,38 sewing machines,39 and kitchen utensils.40

The homestead exemption, which exists in the vast majority of jurisdictions,41 also serves the purpose of providing necessities of life by permitting the debtor to keep his home. The debtor is thus assured of a place to live as well as the food, household items, and clothing contained therein.42 Homestead exemptions have been applied to modern forms of home ownership, including units of a condominium apartment,43 shares of stock in a cooperative apartment corporation,44 and mobile homes.45

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30. See Slyfield v. Willard, 43 Wash. 179, 182, 86 P. 392, 394 (1906); see also Rombauer, supra note 21, at 496.
32. E.g., CAL. CIV. PROC. CODE § 690.1 (West Supp. 1978); IOWA CODE ANN. § 627.6(1) (West 1950). See also Vukowich, supra note 3, at 828.
40. E.g., NEB. REV. STAT. § 25-1556(2) (1975); N.Y. CIV. PRAC. LAW § 5205(a)(5) (McKinney 1978).
41. See, e.g., COWANS, supra note 4, §§ 383-410; 1A W. COLLIER, BANKRUPTCY ¶ 6.15 (14th ed. 1976); MACLACHLAN, supra note 1, § 160, at 158-60; Adams, Homestead Legislation in California, 9 PAC. L.J. 723 (1978); Vukowich, supra note 3, at 797-907; Haskins, Homestead Exemptions, 63 HARV. L. REV. 1289 (1950); Glenn, Property Exempt from Creditors' Rights, 26 VA. L. REV. 127, 135-43 (1929). New Jersey, however, is one of only seven jurisdictions which has no homestead exemption. See N.J. STAT. ANN. § 2A:17-17 (1952). The other jurisdictions which have no homestead exemption are Connecticut, Delaware, District of Columbia, Maryland, Pennsylvania, and Rhode Island. See NAT'L ASS'N OF CREDIT MANAGE-MENT, CREDIT MANUAL OF COMMERCIAL LAWS 556-67 (1978) (chart of state exemptions).

42. "[T]he homestead idea means safety for the debtor." Glenn, supra note 41, at 142.
43. E.g., N.Y. CIV. PRAC. LAW § 4206(a)(3) (McKinney 1978).
44. E.g., N.Y. CIV. PRAC. LAW § 5206(a)(3) (McKinney 1978).
45. E.g., CAL. CIV. PROC. CODE § 690.3 (West Supp. 1978); OR. REV. STAT. § 23.164 (1977). See In re Foley, 97 F. Supp. 843, 847 (D. Neb. 1951), in which the court held that an
Exemption laws which protect various forms of income also assist the debtor in purchasing necessities in the future. Although there are federal restrictions on wage garnishments, state laws may further shield a portion of income from the reach of creditors. Other income forms, such as retirement income and welfare payments, are often exempt.

Since both state and federal legislatures have chosen to keep certain items needed to maintain a minimal standard of living beyond the reach of creditors, the acquisition of such property by the debtor in contemplation of financial disaster should not affect the exemption. It is incongruous for the law to discourage the intentional acquisition of property which the legislature considers necessary for basic living if it is acquired when the debtor is faced with immediate loss of his assets in bankruptcy or by operation of state law. In fact, encouraging the purchase of this type of property would further the goal of providing the debtor and his family with the items necessary for their basic survival and financial support. Consequently, in certain situations, debtors should also be permitted to improve exempt property which is deteriorating or to remove liens and encumbrances from already exempt property.

B. Protecting the Dignity, Culture, and Religious Identity of the Debtor

Most people have property which has significant sentimental value greatly outweighing its monetary worth. If an item has important subjective value to the debtor and would realize a relatively small amount of money on liquidation, respect for the item's personal worth

automobile trailer kept in a trailer court qualified as a homestead, stating "[c]ourts should be very liberal in determining that a sufficient attachment to the property has occurred."


47. E.g., ILL. ANN. STAT. ch. 62, § 73 (Smith-Hurd 1972); KAN. STAT. ANN. § 60-2310(b) (Supp. 1977); N.M. STAT. ANN. § 36-14-7(A) (1972); WASH. REV. CODE ANN. § 7.33.280 (Supp. 1977).


to the debtor should dictate that the property be exempt from the creditor’s grasp.

This rationale justifies many of the exemption laws today, including those for Bibles, family pictures, wedding rings and other jewelry, books, cemetery plots, seats occupied in places of worship, and domestic pets. The importance of these items is not their monetary value nor the physical survival of the debtor; they relate instead to the cultural, religious, and moral aspects of life which should be preserved despite the debtor’s financial hardship. The homestead exemption also furthers this purpose by permitting the debtor to stay in his home and to maintain community ties and social stability. Financial disaster will not then be totally destructive of the debtor’s cultural and moral identity.

In general, exemptions based solely on this policy are aimed at property which the debtor has owned for a substantial period of time or which was acquired at a particular event or moment in life. Therefore, exemptions designed to serve this social policy should not be applied to property purchased in contemplation of bankruptcy for the purpose of maximizing the benefits of the exemption laws; a debtor should not be permitted to stock up on wedding rings and domestic pets in order to defeat creditors’ claims.

C. Enabling the Debtor to Rehabilitate

It is in the best interest of both the debtor and the creditor to assist the debtor to earn income in the future in the absence of bankruptcy. Permitting the debtor to earn income increases the probability that future creditors will be paid. To allow the first-grabbing creditors to take those items that aid in the production of income, however, leaves other creditors with little likelihood that the debtor will be able to replenish his assets. One of the policies furthered by the bankruptcy laws is to assist the debtor in his fresh start and financial

50. E.g., N.Y. CIV. PRAC. LAW § 5205(a)(2) (McKinney 1978); VA. CODE § 34-26(1) (1976).
51. E.g., ALA. CODE tit. 6, § 6-10-6 (1977); N.Y. CIV. PRAC. LAW § 5205(a)(2) (McKinney 1978); OKLA. STAT. ANN. tit. 31, § 1(6) (Supp. 1978).
57. N.Y. CIV. PRAC. LAW § 5205(a)(4) (McKinney 1978).
rehabilitation. The desirability of allowing the debtor to remain income-producing must be balanced against the need to satisfy creditors' claims in bankruptcy, although creditors whose claims are discharged do not benefit by permitting the debtor to keep property needed to produce future income. Thus, whether or not the debtor becomes bankrupt, the need for his financial rehabilitation justifies certain exemptions under state law, the most common of which are tools of the trade and machinery, books used in business, and farming implements.

If the debtor's ability to continue in his trade depends in part on his tools, it makes sense to permit him to purchase such tools in contemplation of bankruptcy. A debtor who is a plumber unable, because of his financial problems, to make normal replacements of tools that had lost efficiency due to normal wear and tear, should be permitted to make reasonable improvements to his old tools or to make reasonable purchases of new tools necessary for his effective continuation in the trade. Such purchases on the eve of bankruptcy will assist the debtor in making a fresh start.

D. Protecting the Debtor's Family

Many courts have identified the protection of the debtor's family and dependents as a primary justification for exemption laws. An examination of some exemption statutes shows that the legislators intended to shield family members from impoverishment. Many exemptions apply only when the debtor is the head of a household.

Every state exempts life insurance proceeds from the reach of the policy owner's creditors. Some exempt the cash surrender value of...
whole life policies as well as the proceeds payable upon death.\(^6\) Many states also exempt life insurance proceeds from the beneficiary's creditors\(^7\) if the beneficiary is a dependent or a relative of the insured debtor.\(^6\) Exemptions that protect earnings,\(^6\) retirement income,\(^7\) welfare payments,\(^7\) household goods,\(^7\) and the homestead itself\(^7\) from creditors' claims also further the social policy of protecting families of debtors.

Exemption laws also protect debtors' families by helping to preserve family stability. Economic hardship is a significant cause of family breakdown and increases the likelihood of divorce.\(^7\) Permitting the family to keep property necessary for basic living minimizes extreme impoverishment and helps the family unit to remain intact.

Exemption laws further the policy of protecting families and dependents in times of economic disaster in two ways. First, property already owned by the family and needed for basic living may be shielded from creditors. Second, in contemplation of the loss of assets to levying creditors or to a trustee in bankruptcy, a debtor may be encouraged to acquire or to make needed improvements to those items that the legislature has designated as necessary for family survival and therefore exempt.

E. Shifting the Burden of Welfare from Society to Creditors

Assuming that exemptions are necessary and effective in the financial rehabilitation of debtors, if state and federal governments did not grant any exemptions, society would have to support debtors in the form of welfare payments.\(^7\) Therefore, another policy furthered by

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\(^6\) E.g., ILL. ANN. STAT. ch. 73, § 850 (Smith-Hurd 1965); MISS. CODE ANN. § 85-3-11 (1973); N.Y. INS. LAW § 166 (McKinney Supp. 1977). In several cases, the life insurance exemption was extended to the cash surrender value by judicial interpretation. Home Security Life Ins. Co. v. McDonald. 277 N.C. 275, 282, 177 S.E.2d 291, 296-97 (1970); In re White, 185 F. Supp. 609, 612-13 (N.D. W. Va. 1960). See Joslin, supra note 65, at 370; Vukowich, supra note 3, at 808.

\(^7\) E.g., CAL. CIV. PROC. CODE § 690.9 (West Supp. 1978); VT. STAT. ANN. tit. 8, § 3706 (1971), VA. CODE ANN. § 38.1-482 (1976). See Joslin, supra note 5, at 370; Vukowich, supra note 3, at 809.


\(^6\) See note 47 and accompanying text supra.

\(^7\) See note 48 and accompanying text supra.

\(^7\) See note 49 and accompanying text supra.

\(^7\) See notes 31-40 and accompanying text supra.

\(^7\) See notes 41-45 and accompanying text supra.

\(^7\) See Lee, The Counseling of Debtors in Bankruptcy Proceedings, 45 AM. BANKR. L.J. 387, 388 (1971); Vukowich, supra note 3, at 785-86.

\(^7\) It is interesting to note that many exemption laws do not apply to tax liabilities. See, e.g., VA. CODE ANN. §§ 34-3, 34-5 (1978). See also Countryman, supra note 10, at 708; Joslin, supra note 65, at 375; Kennedy, supra note 9, at 484. A consequence of the tax exception is
exemption laws is to shift the cost of the debtor's survival from society to his creditors.\textsuperscript{76} The wisdom of this policy aside, it is consistent to permit the debtor to make improvements to his exempt assets or to purchase new exempt property on the eve of bankruptcy, so long as the items improved or purchased will at least partially relieve the debtor of the need for governmental assistance.

### III. THE PROBLEMS

Although consistent with most of the policies furthered by exemption laws, several problems may result if courts uphold the acquisition or improvement of exempt property on the eve of bankruptcy. First, many exemptions are no longer relevant to the social policies which justify exemption laws and serve no useful function in modern society. State exemption statutes have been criticized for being seriously obsolete;\textsuperscript{77} some have remained virtually unchanged since their enactment in the nineteenth century and are deeply rooted in a rural society despite subsequent urbanization. Extreme obsolescence is exemplified in the State of Maine, where even after statutory revision in 1977, five tons of anthracite coal, fifty dollars worth of wood, and ten sheep remain exempt.\textsuperscript{78} There is a serious need to reevaluate state exemption laws and to conform the exemptions to the policies being served by shielding property from creditors' claims.

A second problem relates to the open-ended nature of many exemption laws. Some attach fixed dollar limitations to the property which is exempt from creditors.\textsuperscript{79} For example, New York exempts

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that a debt owed to the government may be collected by liquidating all of the debtor's property, thus leaving it up to the state's welfare laws to provide for the debtor's needs. The effect is to have the debtor's needs defined by welfare laws, which are specifically designed to accommodate improverished people from general tax revenues, rather than by exemption laws, which are designed to balance the needs of the debtor with the interests of creditors. When the government is the creditor, there is no need to balance the debtor's interest with that of the creditor; it is more appropriate to let the welfare laws govern.

76. The purpose of exemption laws is "to keep [debtors] from being reduced to absolute destitution and thereby public charges." Southwest State Bank v. Quinn, 198 Kan. 359, 363, 424 P.2d 620, 624 (1967); see Patten Package Co. v. Houser, 102 Fla. 603, 606-07, 136 So. 353, 355 (1931); Collier, supra note 41, ¶ 6.03[1]; Vukovich, supra note 3, at 867-69; 68 YALE L.J., supra note 2, at 1497-1502; 53 CORNELL L. REV., supra note 9, at 665. "[I]t has been deemed advantageous to place the burdens of credit-related social welfare problems on the creditor rather than on the community." 35 U. PITT. L. REV., supra note 5, at 632.

77. See Countryman, Consumer Bankruptcy—Some Recent Changes and Some Proposals, 19 U. KAN. L. REV. 165, 167 (1971); Countryman, supra note 10, at 681-84; Joslin, supra note 65, at 366; Kennedy, supra note 9, at 448; 53 CORNELL L. REV., supra note 9, at 669-70; STANLEY & GIRTH, supra note 29, at 81.

For a discussion of how courts have "tortured statutory construction" in attempts to modernize outdated exemption laws, see 53 CORNELL L. REV., supra note 9, at 670.


“a watch not exceeding thirty-five dollars in value” and “necessary working tools and implements . . . not exceeding six hundred dollars in value,”80 while North Dakota puts a sixty-thousand-dollar ceiling on the homestead exemption.81 The new federal exemptions under the Bankruptcy Reform Act include the debtor’s interest, “not to exceed $1,200 in value, in one motor vehicle.”82 Other exemption laws have quantity limitations.83 California exempts one vehicle and Maine twelve cord of fire wood.85 New York exempts “all necessary food actually provided for the use of the judgment debtor or his family for sixty days,”86 while Florida permits the debtor to keep a homestead of 160 acres of rural land or one-half acre of urban land.87

On the other hand, many exemption laws either have no value or quantity limits at all, or have extremely high limits. The most notable example of the latter is the homestead law of Texas, which exempts a rural ranch of two-hundred acres regardless of worth.88 The New York law exempts the entire cash surrender value of the debtor’s life insurance policies89 and all the debtor’s household furniture,90 without any monetary limitations. It is possible, therefore, for the Texas debtor to keep his million-dollar ranch as a homestead and for the New York debtor to keep his multimillion-dollar whole life insurance policy free from creditors’ claims even in bankruptcy.91 Other exemptions are limited by the concept of necessity; Connecticut, for example, exempts necessary “apparel, bedding, foodstuffs, household furniture and appliances.”92

The obsolescence and open-endedness of many state exemption laws enable debtors to keep property beyond the reach of creditors when no justifiable social policy is served and when creditors are thereby unduly restricted in their attempts to obtain payment of their claims. The problems resulting from this obsolescence and open-
endedness would be compounded were debtors encouraged, or even permitted, to purchase exempt property on the eve of bankruptcy. It would be outrageous even to suggest that an insolvent Texas debtor be permitted to invest one hundred thousand dollars to improve his homestead ranch one day before filing a bankruptcy petition, or for an urban debtor in Maine to purchase five tons of anthracite coal or ten sheep for the sole purpose of putting his assets out of the reach of his creditors. These problems have not been resolved by the Bankruptcy Reform Act. Because the debtor retains the right to elect state exemption laws as an alternative to the federal bankruptcy exemptions, the potential for abuse of state laws continues.

IV. JUDICIAL TREATMENT OF EXEMPTIONS OBTAINED ON THE EVE OF BANKRUPTCY

Exemption laws are not intended to benefit dishonest debtors who are guilty of fraudulent conduct which relates to the property claimed as exempt. Some state statutes expressly provide that exemptions shall be denied to such debtors. Even absent explicit statutory exclusions, courts have disallowed exemptions when the debtor has committed a fraud which involved exempt property. The present Bankruptcy Act is generally silent on the effect of fraudulent conduct on the debtor's right to keep exempt property out of the reach of creditors. The Act does provide, however, that the exemption is forfeited when the debtor transfers or conceals exempt property under circumstances that would give the trustee the right to avoid the transfer as a fraudulent conveyance or a voidable preference. The Bankruptcy Reform Act maintains this silence, retaining the trustee's

93. See note 88 and accompanying text supra.
94. See note 78 and accompanying text supra.
95. See note 17 and accompanying text supra.
96. While it is well-established law that exemptions in behalf of unfortunate debtors are to be liberally construed in furtherance of the object of such statutes . . . [s]o also must it be remembered that courts of bankruptcy proceed upon equitable principles, and should no more sustain a positive fraud than would a court of equity. In re Gerber, 186 F. 693, 696 (9th Cir. 1911). See also In re Prestien, 427 F. Supp. 1003, 1008 (S.D. Fla. 1977); In re Alex, 141 F. 483 (E.D. Pa. 1905) (report of referee); Slatcoff v. Dezen, 76 So. 2d 792 (Fla. 1954) (en banc).
97. See N.Y. INS. LAW § 166(4) (McKinney 1966); OKLA. STAT. ANN. tit. 36, § 3631(b) (West 1976). See also In re Newberger, 1 F. Supp. 685 (W.D. Okla. 1932).
98. Miguel v. Walsh, 447 F.2d 724, 726 (9th Cir. 1971) (exemption denied for property purchased with funds fraudulently obtained). See Esty v. Cummings, 75 Minn. 549, 554, 78 N.W. 242, 244 (1899) (homestead exemption not to be used as a vehicle for fraud and rank injustice); COLLIER, supra note 41, ¶ 6.11[2], at 848 (bankrupt guilty of fraudulent conduct in his affairs denied generally the right to claim exemptions in bankruptcy proceedings). See also Countryman, supra note 10, at 740-46; Eisenberg, Denial of Exemptions in Bankruptcy Proceedings, 81 COM. L.J. 510 (1976); Vukovich, supra note 3, at 865-66.
power to avoid such a transfer. The many courts which have considered whether a debtor should be permitted to convert nonexempt assets into exempt property while experiencing financial difficulties and contemplating bankruptcy have treated the issue as one governed solely by state law.

A. Purchase of Exempt Property by an Insolvent Debtor is Not Fraudulent Per Se

It is well settled that the conversion of nonexempt to exempt property by an insolvent debtor is not, in and of itself, a fraud on creditors. This rule has been applied to uphold exemptions acquired by insolvent debtors who subsequently file bankruptcy petitions, regardless of the time period between the acquisition of exempt property and the commencement of the bankruptcy action.

A frequently cited justification for permitting the debtor to keep exempt property purchased while insolvent and on the eve of bankruptcy is that the legislation or the state constitutional provision conferring the exemption is absolute and without exception. Courts have been reluctant to interpret exemption laws to infer an exception for property purchased in contemplation of bankruptcy. This approach, based on a literal reading of exemption laws, is consistent with the general doctrine that these laws are to be liberally construed.

101. See notes 103-53 infra.
102. See Huenergardt v. John S. Brittain Dry Goods Co., 116 F. 31, 33 (8th Cir. 1902); In re White, 221 F. Supp. 64, 67 (N.D. Cal. 1963); In re Dudley, 72 F. Supp. 943 (S.D. Cal. 1947), aff’d sub nom. Goggin v. Dudley, 166 F.2d 1023 (9th Cir. 1948); In re Hammonds, 198 F. 574, 575-76 (E.D. Ky. 1912).
103. See, e.g., In re Adlman, 541 F.2d 999 (2d Cir. 1976); In re Jackson, 472 F.2d 589 (9th Cir. 1973); Wudrick v. Clements, 451 F.2d 988 (9th Cir. 1971); Forsberg v. Security State Bank, 15 F.2d 499 (8th Cir. 1926); Crawford v. Sternberg, 220 F. 73 (8th Cir. 1915); In re Driscoll, 142 F. Supp. 300 (S.D. Cal. 1956); In re Dudley, 72 F. Supp. 943 (S.D. Cal. 1947), aff’d sub nom. Goggin v. Dudley, 166 F.2d 1023 (9th Cir. 1948).

In Crawford, the court wrote: “It is well settled that it is not a fraudulent act by an individual who knows he is insolvent to convert a part of his property which is not exempt for the purpose of claiming his exemptions therein, and of thereby placing it out of the reach of his creditors.” 220 F. at 76. See generally COLLIER, supra note 41, ¶ 6.11[5]; Kennedy, supra note 9, at 476.

104. See Love v. Menick, 341 F.2d 680 (9th Cir. 1965) (deposit of $1,000 in federal savings and loan association two days before bankruptcy); Crawford v. Sternberg, 220 F. 73 (8th Cir. 1915) (nonexempt partnership funds distributed to individual partners in order to gain exemption one day prior to bankruptcy); In re Irvin, 120 F. 733 (8th Cir. 1903) (nonexempt store converted to exempt homestead six days prior to bankruptcy); In re Dudley, 72 F. Supp. 943 (S.D. Cal. 1947), aff’d sub nom. Goggin v. Dudley, 166 F.2d 1023 (9th Cir. 1948) (exempt shares in building and loan association purchased one week prior to bankruptcy).

105. See Forsberg v. Security State Bank, 15 F.2d 499 (8th Cir. 1926); Crawford v. Sternberg, 220 F. 73, 76 (8th Cir. 1915); Kelly v. Sparks, 54 F. 70, 72-73 (C.C.D. Kan. 1893); In re Dudley, 72 F. Supp. 943 (S.D. Cal. 1947), aff’d sub nom. Goggin v. Dudley, 166 F.2d 1023 (9th Cir. 1948); In re Hammonds, 198 F. 574, 576 (E.D. Ky. 1912).
in favor of the debtor. Nevertheless, such an approach results in blindly upholding purchases of exempt property by the financially distressed debtor without regard to the equities of the particular case and without any judicial balancing of the interests of debtors and creditors. The policies behind exemption laws, and their possible abuse by the insolvent debtor who acquires more property than is appropriate for furthering those policies, are not considered. This results from the questionable notion that if legislators intended to except purchases in contemplation of bankruptcy, exemption laws would expressly state appropriate exceptions for them. The absence of express exceptions should not, however, in and of itself, preclude a finding that the purchase of exempt property under such circumstances was an abuse of the exemption and a fraud on creditors.

Another rationale for permitting debtors to keep exempt property acquired on the eve of bankruptcy is that creditors are presumed to have knowledge of exemption laws and therefore to have assumed the risk that debtors will invest their assets in exempt property while experiencing financial difficulties. This rationale is based on the belief that creditors consciously consider the purchase of exempt property as a risk of extending credit. It is doubtful that creditors actually assume such a risk, especially in states which have open-ended exemption laws. Nevertheless, the purchase of five tons of anthracite coal or a five-hundred-thousand-dollar life insurance policy the day before the commencement of a bankruptcy petition which results in the depletion of the debtor's estate might be a risk which creditors should not be required to bear.

An early case which approved exempt purchases by an insolvent debtor based on this rationale, without regard to the equities of the situation or the policies behind the particular exemption involved, was Kelly v. Sparks. In Kelly, a debtor sold his nonexempt assets and used seven thousand dollars of the proceeds to buy and improve 160 acres of farming land, the maximum amount of land which qualified under the homestead provision of the Constitution of the State of Kansas. Although the debtor did not become a bankrupt, the

106. See Doethlaff v. Penn Mutual Life Ins. Co., 117 F.2d 582, 584 (6th Cir. 1941) (debtor entitled to liberal construction of exemption statute); Crawford v. Sternberg, 220 F. 73, 76-77 (8th Cir. 1915) (exemption statutes to be construed liberally in favor of exemption); see also Love v. Menick, 341 F.2d 680, 682 (9th Cir. 1965); Forsberg v. Security State Bank, 15 F.2d 499, 501 (8th Cir. 1925); In re Gerber, 186 F. 693, 696 (9th Cir. 1911). See Kennedy, supra note 9, at 448.

107. See In re Wilson, 123 F. 20, 22 (9th Cir. 1903); First National Bank v. Glass, 79 F. 706, 707 (8th Cir. 1897); In re Hammonds, 198 F. 574, 576 (E.D. Ky. 1912).

108. See note 78 and accompanying text supra.

109. See note 89 and accompanying text supra.

110. 54 F. 70 (C.C.D. Kan. 1893).

111. KANS. CONST. art. 15, § 9 provides in pertinent part:

Homestead exemption. A homestead to the extent of one hundred and sixty acres of farming land, or of one acre within the limits of an incorporated town or city,
purchase was made after the debtor’s business had failed, when he knew that he was insolvent “and in securing the homestead doubtless had in view primarily the purpose of providing a home for himself and family, which should be exempt from the claims of his creditors.” The circuit court recognized that “it seems harsh and unjust that a debtor may live in wealth, under the provisions of a homestead law, while his creditors are kept out of what is justly due them.” Nonetheless, the court upheld the exemption on the ground that it was a matter for the legislature, which had made no exception for exemptions purchased while the debtor was insolvent. The court also noted that the debtor had been given credit “in full view of this comprehensive exemption.”

The reasoning of the Kelly court was also used when an insolvent debtor commenced a bankruptcy proceeding soon after exempt property was obtained. In In re Dudley, a debtor had purchased one thousand dollars worth of stock in a building and loan association, which was exempt under a California statute, one week prior to his adjudication as a bankrupt, when he was “heavily in debt and clearly insolvent.” The district court upheld the exemption and rejected the bankruptcy referee’s finding of actual fraud by the debtor. The court held that the conversion, immediately prior to bankruptcy and while the debtor is insolvent, of nonexempt to exempt property, thereby placing it out of the reach of creditors, was permitted in the absence of a showing of extrinsic fraud.

The California statute places no time limit on the exemption of building and loan stock to the value of one thousand dollars. It does not say when building and loan stock must be acquired in order to be exempt. Nor does it say that the person shall be solvent at the time of acquisition. To sustain the Referee in this case, we would have to impose a time limit and make solvency a condition precedent to exemption. This would mean reading into the state statute restrictions which are not there. And this we cannot and should not do.

The rule permitting insolvent debtors to buy exempt property prior to bankruptcy has been applied to transactions which did not involve cash purchases, but were transfers or changes in use designed to afford the debtor the benefits of exemption laws. A debtor who, in

occupied as a residence by the family of the owner, together with all the improvements on the same, shall be exempted from forced sale under any process of law.

112. 54 F. at 71.
113. Id. at 72-73.
114. Id. at 73.
115. Id.
117. See CAL. CIV. PROC. CODE § 6.90.7 (West Supp. 1978).
118. 72 F. Supp. at 944.
119. Id. at 947.
contemplation of bankruptcy and six days before his failure, moved his family from a rented house into a room in a building that had previously been used as a billiard hall, storehouse, and restaurant, was permitted to claim the building as an exempt homestead. In another case, the Eighth Circuit upheld a debtor's right to keep twenty-one exempt sheep that the debtor had received in a trade for his nonexempt hogs and cattle, even though the insolvent debtor had contemplated bankruptcy at the time of the trade and had indeed filed a petition within one month thereafter.

It has been held that an insolvent debtor may make mortgage payments on an exempt homestead in contemplation of bankruptcy, thereby maximizing the amount of his equity free from the claims of creditors. Insolvent debtors have been permitted to benefit by paying premiums on exempt life insurance policies or by paying off loans secured by those exempt policies. The cases that allowed these benefits relied on the general principle that the conversion of nonexempt to exempt property in contemplation of bankruptcy is not fraudulent per se.

B. Denial of Exemption When Actual Fraud is Found

Although exemptions are upheld despite a debtor's insolvency and his expectation of bankruptcy, exemption claims have been disallowed when the debtor has committed actual or extrinsic fraud in connection with the acquisition of otherwise exempt property. The exemption will be denied if the trustee in bankruptcy or creditors can

120. In re Irvin, 120 F. 733 (8th Cir. 1903).
121. Forsberg v. Security State Bank, 15 F.2d 499 (8th Cir. 1926).
123. See In re Adlman, 541 F.2d 999 (2d Cir. 1976), discussed at notes 170-77 and accompanying text infra; Doethlaff v. Penn Mut. Life Ins. Co., 117 F.2d 582 (6th Cir. 1941); cf. Greiman v. Metropolitan Life Ins. Co., 96 F.2d 823 (3d Cir. 1938) (life insurance premiums paid in fraud on creditors recoverable from proceeds of policy on death of insured).
124. See In re Adlman, 541 F.2d 999 (2d Cir. 1976); Schwartz v. Seldon, 153 F.2d 334 (2d Cir. 1945); In re Driscoll, 142 F. Supp. 300 (S. D. Cal. 1956); In re Silansky, 21 F. Supp. 41 (E. D. Pa. 1937). See generally In re Yaeger, 21 F. Supp. 324 (W. D. N.Y. 1937). In Yaeger, the entire insurance policy was held conditionally exempt despite the repayment of a loan to the insurance company in anticipation of bankruptcy. Upon change of the beneficiary for the personal advantage of the bankrupt or upon maturity during the debtor's lifetime, however, the cash surrender value of the policy on the date of bankruptcy adjudication would become "unadministered assets of the bankrupt's estate." In addition, the bankrupt's right to borrow against the cash surrender value of the policy was limited to the extent that he could not impair the contingent interest of the bankruptcy estate in the policy. The court reasoned that the rationale supporting the life insurance exemption was the protection of the beneficiary, not the insured bankrupt. Id. at 325-26. See Comment, 51 HARV. L. REV. 1102 (1938).
125. See Kangas v. Robie, 264 F. 92 (8th Cir. 1920); In re Majors, 241 F. 538 (D. Or. 1917); In re White, 221 F. Supp. 64 (N. D. Cal. 1963); In re Martin, 217 F. Supp. 937 (D. Or. 1963). See COLLiER, supra note 41, ¶ 6.11[5].
prove by clear and convincing evidence\textsuperscript{126} that the purchase of exempt property was accompanied by actual fraud.

It is not always easy to reconcile the decisions which differentiate between factual situations involving actual fraud resulting in the denial of exemptions and those found to involve no actual fraud.\textsuperscript{127} The mere fact that the insolvent debtor expects to become a bankrupt at the time he converts his nonexempt property to exempt property is not sufficient to constitute actual fraud.\textsuperscript{128} Courts have considered neither the amount of exempt property acquired\textsuperscript{129} nor the time of acquisition\textsuperscript{130} as the distinguishing factor.

Several courts have held that there is actual fraud when the funds invested in the exempt property were obtained from the sale of goods which were purchased on credit and for which payment was not made.\textsuperscript{131} In \textit{In re White},\textsuperscript{132} copartners consulted with counsel and received advice as to possible exemptions under California law. Despite their intention to terminate their business and commence bankruptcy proceedings, the partners continued to purchase goods on credit and resell them for cash in the ordinary course of business. The proceeds of those sales were not used to pay for the goods, but were used instead to enable each debtor to deposit one thousand dollars in a federal savings and loan association account and fifteen hundred dollars in a credit union account, the maximum amounts of such deposits exempt under state law.\textsuperscript{133} Upholding the referee, the district court ruled that there was factual support for a finding of ac-

\textsuperscript{126} See Love v. Menick, 341 F.2d 680, 682 (9th Cir. 1965).
\textsuperscript{127} Professor MacLachlan noted:

This generally has been treated as a question of state law, and it has not been altogether clear whether the cases show a split of authority or whether they can be reconciled as giving effect to different statutory policies or as representing judicial determinations based upon important differences of fact.

\textit{MacLachlan, supra} note 1, at 161. \textit{See Collier, supra} note 41, ¶ 6.11[5] ("The distinction is often a close one and depends entirely upon the facts.").

\textsuperscript{128} See Wudrick v. Clements, 451 F.2d 988 (9th Cir. 1971); Schwartz v. Seldon, 153 F.2d 334, 337 (2d Cir. 1945); Forsberg v. Security State Bank, 15 F.2d 499 (8th Cir. 1926); Crawford v. Sternberg, 220 F. 73 (8th Cir. 1915); \textit{In re Hammonds}, 198 F. 574 (E.D. Ky. 1912); \textit{In re Irvin}, 120 F. 733 (8th Cir. 1903); \textit{In re Driscoll}, 142 F. Supp. 300, 302 (S.D. Cal. 1956). \textit{But see} Shanks v. Hardin, 101 F.2d 177 (6th Cir. 1939), discussed at notes 150-51 and accompanying text \textit{infra}.

\textsuperscript{129} See \textit{In re Adlman}, 541 F.2d 999 (2d Cir. 1976), in which the debtor prepaid life insurance premiums and paid off loans to the insurance company in excess of $50,000 prior to bankruptcy. The court in \textit{Adlman} did not seem to consider relevant the amount of money converted into exempt life insurance. The case is discussed at notes 170, 177 and accompanying texts \textit{infra}.

\textsuperscript{130} See note 104 and accompanying text \textit{supra}.

\textsuperscript{131} Kangas v. Robie, 264 F. 92 (8th Cir. 1920); \textit{In re White}, 221 F. Supp. 64 (N.D. Cal. 1963). \textit{Contra}, \textit{In re Wilson}, 123 F. 20 (9th Cir. 1903); \textit{In re Hammonds}, 198 F. 574, 575 (E.D. Ky. 1912).

\textsuperscript{132} 221 F. Supp. 64 (N.D. Cal. 1963).

tual fraud, in that the bankrupts acquired credit without intending to repay. Because the fraud was committed to enable the debtors to take advantage of state exemption laws, the trustee was permitted to seize the funds in the exempt accounts.

It could be argued that the debtors in White committed a fraudulent act independent of the acquisition of exempt property. They obtained credit without intending to make repayment. If the debtor had purchased goods on credit without intending to pay for them and had used the proceeds of resale to prefer a favorite creditor rather than to purchase exempt property, his conduct would nonetheless constitute a fraud which might result in the nondischargeability of the debt. Instead of barring discharge of the debt based on fraudulent inducement to extend credit, the court in White simply denied the debtors' exemption.

Another factual situation which might result in the denial of exemptions involves the distribution of partnership assets to general partners to finance the purchase of exempt property. An early Eighth Circuit decision upheld the right of partners in an insolvent firm to sever property from the firm for the purpose of acquiring individual exemptions in anticipation of a partnership bankruptcy proceeding. The court did not consider this to be fraudulent and permitted the partners personally to keep the exempt property at the expense of creditors of the business. This decision was nullified in

134. Section 17(a) of the present Bankruptcy Act provides: "A discharge in bankruptcy shall release a bankrupt from all of his provable debts . . . except such as . . . (2) are liabilities for obtaining money or property by false pretenses or false representations. . . ." 11 U.S.C. § 35(a) (1970). A similar provision is contained in the Bankruptcy Reform Act, Pub. L. No. 95-598, § 523(a)(2), 92 Stat. 2549 (to be codified in 11 U.S.C. § 523(a)(2)). The present section has been applied to declare debts nondischargeable when the debtor incurred the debts without intending to make payment. Incurring debt without intending to make payment is obtaining credit by a "false pretense." In re Black, 373 F. Supp. 105 (E.D. Wis. 1974); but see Davison-Paxon Co. v. Caldwell, 115 F.2d 189 (5th Cir. 1940), cert. denied, 313 U.S. 564 (1941). See generally Collier, supra note 41, § 17.16; Cowans, supra note 4, at § 263.

135. The opinion of the court contained dictum which suggested that the fraud committed might result in nondischargeability of debts as well as the forfeiture of the exemption. The court stated:

In short, the instant case is analogous to a situation wherein a debtor requests a loan from a bank, secures such a loan, immediately invests the proceeds of that loan in exempt property, and files a petition in bankruptcy. This latter course of action would, in the opinion of the Court, constitute grounds for the denial of discharge in bankruptcy, under the provisions of § 17, sub. a(2) of the Bankruptcy Act. . . . Since the instant situation does not, on the present record, appear to be as flagrant as the above analogy, nothing said here should be construed as a ruling (one way or the other) on the matter of the propriety of the discharge of the bankrupts in this case. If and when the matter of the discharge of the bankrupts comes up, it will have to be considered initially by the Referee on the record then before him.

221 F. Supp. at 67.


137. But see Amundson v. Folsom, 219 F. 122 (8th Cir. 1914), in which the court reasoned:

It may be true, as argued, that creditors of a partnership merely as such have not a lien on partnership assets, as distinguished from an equity in their administration,
1938 by an amendment to the Bankruptcy Act, which provides that every transfer of partnership property to a partner within one year of the bankruptcy of the firm, when the partnership was insolvent or became insolvent because of the transfer, is a fraud on partnership creditors, without regard to the actual intent of the parties.138 The result is that the trustee may void the transfer of property from the partnership to the individual partners and return it to the partnership estate, even if the individuals have converted the assets into exempt property.139 It is uncertain whether the partners would also lose the exemption if a bankruptcy petition is not filed on behalf of the partnership, but the partners instead file individual petitions.140 Because this situation is covered neither by the amendment to the present Bankruptcy Act nor by the Bankruptcy Reform Act, it remains to be seen whether the purchase of exempt property with funds distributed from an insolvent partnership business would be upheld today.

Another situation in which a court found actual fraud involved a debtor who invested substantial assets in exempt property after inducing his creditors to withdraw an involuntary petition in bankruptcy. In In re Gerber,141 the business creditors of an insolvent individual filed an involuntary bankruptcy petition shortly after the debtor made a down payment on the purchase of real estate. The debtor vigorously contested the petition, eventually stipulating with the petitioning creditors that the proceeding be dismissed in exchange for his consent to be adjudged a bankrupt upon the filing of a new petition by another group of creditors. During the one day interim between the dismissal and the filing of a new petition, the debtor paid the balance

or that the members of an insolvent firm may lawfully sever their relation, and one sell his interest in the firm property to the other, or that a debtor in failing circumstances can turn business assets into exempt property and hold it, or that one may lawfully purchase a stock of goods in bulk from another, or, finally, that it is not in itself fraudulent for an insolvent debtor merely to make a preferential transfer, or for his creditor to receive it. But all such things, especially when in close consecutive association, are to be considered, with what else appears, in determining whether the result was the consummation of a preconceived purpose to hinder, delay, or defraud creditors.

Id. at 125.


139. In re Reese, 223 F. Supp. 626 (N.D. Cal. 1963). Because the transfer is fraudulent under § 67(d)(4), the proviso of § 6 applies to nullify the exemption. See note 9 supra; COLLIER, supra note 41, ¶ 6.09[6].


141. 186 F. 693 (9th Cir. 1911).
of the purchase price on the real estate, received the deed, and filed a certificate declaring the property as a homestead. The court found that the debtor's conduct was designed fraudulently to induce the dismissal of the first petition in order to enable him to complete the purchase of the exempt homestead. It disallowed the exemption because "no court acting upon equitable principles should sustain such a transaction."

C. The Role of Motive in Finding Actual Fraud

Several courts have indicated that the purpose for which the exempt property was acquired is an important factor in determining whether the acquisition was a fraud on creditors. In re Majors is an early case in which a court denied an exemption on the sole ground that the insolvent debtor acquired the exempt property with the motive to deprive creditors of assets. In Majors, the debtor had purchased certain exempt farm equipment and livestock prior to filing a voluntary bankruptcy petition. The court found that the debtor was not motivated by a desire to own such property, but was instead interested in depriving his creditors of assets. The court relied on the testimony of the debtor to prove that his "direct and especial reason for purchasing the property, was, as he has expressed it, that otherwise his creditors would have taken everything he had." Based on the debtor's motive, the court found actual fraud so as to deprive him of the exemption.

An Eighth Circuit decision also indicates that an improper motive will be enough to make the acquisition of exempt property fraudulent. The debtor in Kangas v. Robie was a merchant who spent thirteen thousand dollars of the proceeds from his insolvent business to purchase a homestead prior to filing a bankruptcy petition. The court distinguished the cases which permitted an insolvent debtor to

142. Some state homestead exemption laws require that the debtor file a formal declaration as a condition precedent to the establishment of the property as a homestead. See Haskins, Homestead Exemption, 63 HARV. L. REV. 1289, 1297-99 (1950). For a list of states that require the filing of homestead declarations, see NATIONAL ASS'N OF CREDIT MANAGEMENT, CREDIT MANUAL OF COMMERCIAL LAWS 554-55 (1978).

143. 186 F. at 697.

144. See Shanks v. Hardin, 101 F.2d 177 (6th Cir. 1939); Kangas v. Robie, 264 F. 92, 94 (8th Cir. 1920); In re Martin, 217 F. Supp. 937 (D. Or. 1963); In re Majors, 241 F. 538 (D. Or. 1917).

145. 241 F. 538 (D. Or. 1917).

146. Id. at 540. The district court quoted the debtor's testimony as follows:
   Q: Instead of paying your debts, you put it [the money] into exempt property?
   A: Yes, sir; I had to.
   Q: Why did you have to?
   A: Because they would have taken everything I had.

147. 264 F. 92 (8th Cir. 1920).
purchase exempt property in anticipation of bankruptcy.\textsuperscript{148} "The situation which petitioner presents to us is a confession of bad faith on his part, that the purpose with which he took title to the property which he now claims as exempt was to defraud his creditors, and we must decline to give it our approval."\textsuperscript{149}

The motive of an insolvent debtor who obtained twenty-five acres of farmland on the eve of bankruptcy was also the determining factor in depriving him of a homestead exemption in \textit{Shanks v. Hardin}.\textsuperscript{150} The debtor owned a nonexempt one-fifth undivided interest in a farm, his brothers and sisters owning the remaining four-fifths. The execution by his brothers and sisters of deeds to the insolvent debtor allowed him to receive twenty-five acres of the land as his sole separate property, which qualified as an exempt homestead. Four days after the deeds were recorded the debtor filed a voluntary bankruptcy petition. The court emphasized that the purpose of the partition deeds was to prevent creditors from reaching the debtor's interest in the land. This "express purpose of defeating his creditors"\textsuperscript{151} was the basis for denial of the exemption.

In theory, it is logical to distinguish between situations that involve an intent to deprive creditors of assets and situations in which the debtor's purpose is actually to acquire the exempt property. Bankruptcy legislation and state exemption laws were not designed to protect the debtor who acts in bad faith to deprive his creditors of assets.\textsuperscript{152} The debtor who obtains exempt property because he has a good faith desire to own such property is not acting with fraudulent intent and, therefore, should be permitted to keep the property free of creditors' claims.

There are several problems, however, with using the test of the debtor's purpose to distinguish between those acquisitions of exempt property which are fraudulent and those which are permitted. It is often difficult to determine the purpose for which a debtor obtains exempt property prior to bankruptcy. This determination is further complicated by the likelihood that he is acting upon multiple motives. Suppose a debtor purchases a television set prior to bankruptcy with the knowledge that the television would be exempt under applicable law.\textsuperscript{153} Was the debtor motivated by a desire to own a new television set or was his sole purpose to deprive creditors of his assets and to preserve as much of his property as possible? It is likely that he was motivated by both desires.

\textsuperscript{148} Id. at 93.
\textsuperscript{149} Id. at 94.
\textsuperscript{150} 101 F.2d 177 (6th Cir. 1939).
\textsuperscript{151} Id. at 178.
\textsuperscript{152} See note 96 and accompanying text \textit{supra}.
\textsuperscript{153} The exemption for television sets is discussed at note 35 \textit{supra}. 
Given that the debtor may well have multiple motives, the outcome might be affected by the skillful preparation and questioning of the debtor by his attorney. To illustrate this point, consider a debtor with five hundred dollars of nonexempt cash who is about to file a bankruptcy petition. His attorney, while preparing the schedules which must be filed, asks if the debtor owns a television set, which is exempt under state law. When the debtor replies that he does not, the attorney advises, "If you would like to own a television set, you have the right to purchase one now and you will be permitted to keep it after bankruptcy." The debtor, knowing that he will lose his five hundred dollars of cash in bankruptcy, uses the money to purchase a television set. The exemption would probably be allowed in some states. Suppose, however, that the attorney has asked the debtor whether he would like to keep as much of his assets as possible when he goes bankrupt and suggests that, "If so, you should buy a television set." This advice might influence the debtor's perception of his primary motive, despite his real desire to own a television set. It might also affect his testimony in bankruptcy court when asked about his motive for buying the television set.

154. See M. Freedman, Lawyers' Ethics in an Adversary System 59-77 (1975) for a discussion of the influence of the question in preparing witnesses and interviewing clients. Questioning is, of course, an essential part of interviewing and preparing a witness for trial. It is particularly noteworthy, therefore, that questions, even "straightforward question of fact", may play a very strong part in inducing "importation of detail" into the process of remembering, and that leading questions, when purposefully used to induce error, succeed in doing so to a startling degree. Moreover, memory in general, and responses to questions in particular, will be affected by "preferential psychological reactions"—that is, there is a natural and honest tendency to remember-reconstruct in ways that are "strongly determined by an active subjective bias of the nature of interest".

Id. at 67.


156. See notes 110-24 and accompanying text supra.

157. If the lawyer phrases his questions deliberately to influence his client's primary motive or to affect the client's subsequent testimony concerning his motive, is the lawyer acting unethically? The ABA CODE OF PROFESSIONAL RESPONSIBILITY, Disciplinary Rule 7-102 (A)(6) (1976) provides that a lawyer shall not "[p]articipate in the creation or preservation of evidence when he knows or it is obvious that the evidence is false." Does this rule prohibit the lawyer from informing the client that he can keep exempt property if he has a genuine desire for it, but cannot keep it if his motive is to keep his assets out of the reach of his creditors? For a discussion of this problem, see Freedman, supra note 154, at 59-77. The Code is also ambiguous with respect to whether the lawyer should give the client legal advice that may induce the client to commit perjury. The Code provides that a lawyer shall not "participate in the creation" of evidence when he or she knows or it is obvious that the evidence is false. There again, however, the degree of participation is unclear. For example, what if a client in an uncontested divorce case asks a lawyer which states provide the quickest divorces and what evidence must be presented in each jurisdiction in order to obtain a divorce? It is unlikely
This problem is further illustrated in *In re Martin*, 158 in which a debtor was denied an exemption for a rifle purchased prior to bankruptcy on the advice of counsel. The debtor testified that he had consulted with his attorney about conserving his four hundred dollars of nonexempt cash and that the attorney “told me I was allowed the rifle and a pistol and a whole bunch of exempt articles.” 159 Knowing that he had to spend two hundred dollars for other purposes, the debtor spent the remaining two hundred dollars on a rifle. The referee found that the purchase was “effected with a conscious effort to convert nonexempt assets into exempt assets with the purpose of making them unavailable to the trustee.” 160 The outcome might have been different had the debtor’s attorney first asked his client whether he had a desire to own a rifle, which happened to be exempt under state law. It is unclear how far a lawyer may go in preparing his client for testimony on this issue. 161 Unless the debtor acted with malice toward his creditors, it is highly doubtful that he did not have some desire to own a rifle. It can be argued that the debtor’s attorney had a duty to help the client manifest his desire to own the rifle, even though the client had the dual motives of preserving as many of his assets as possible and of owning a rifle. 162

A second problem with using the purpose test is that the test is insensitive to the quantity or value of exempt property purchased. A debtor who acquires exempt property with the primary motive of owning the specific property might purchase more than is reasonably necessary to fulfill the policy of the particular exemption law. For

that the codifiers intended to forbid the lawyer to explain the requirements of domicile, even though the attorney should “know” (or, at least, it is “obvious” enough to me) that the client is shopping for a forum rather than for a permanent residence. Once again, therefore, I would conclude that the intention of the Code is to forbid active participation by the attorney in creating the perjury, but not to proscribe merely giving relevant legal advice. Clearly, however, such a fundamental and pervasive issue should not be left to uncertain inferences from vague standards. 163

Id. at 61.
159. Id.
160. Id. at 938.
161. See note 157 *supra*.
162. ABA Code of Professional Responsibility, E.C. 7-6 provides: Whether the proposed action of a lawyer is within the bounds of the law may be a perplexing question when his client is contemplating a course of conduct having legal consequences that vary according to the client’s intent, motive, or desires at the time of the action. Often a lawyer is asked to assist his client in developing evidence relevant to the state of mind of the client at a particular time. He may properly assist his client in the development and preservation of evidence of existing motive, intent, or desire; obviously, he may not do anything furthering the creation or preservation of false evidence. In many cases a lawyer may not be certain as to the state of mind of his client, and in those situations he should resolve reasonable doubts in favor of his client.
instance, a debtor motivated by a desire to give maximum protection to his family might purchase a one-million-dollar life insurance policy or a two-hundred-acre ranch in jurisdictions which would so allow. 

D. Sanctions Imposed for Fraudulently Acquiring Exempt Property

Most cases dealing with the propriety of converting nonexempt assets to exempt property in contemplation of bankruptcy have arisen as a result of a trustee's disallowance of the exemption. Usually, the sanction imposed when a conversion is accompanied by actual fraud is denial of the exemption and recovery by the trustee of the otherwise exempt property.

A more drastic sanction which might be imposed against the debtor is the denial of a discharge of his debts. The Bankruptcy Act provides that a debtor shall be discharged from his debts unless the court finds that he has, at any time within one year before the filing of the petition in bankruptcy, transferred, removed, destroyed, or concealed any of his property, with intent to "hinder, delay, or defraud" his creditors. One court has noted that "[a] higher degree of fraud is required to deny a discharge than to deny a claimed exemption." Still, the threat of the denial of a discharge in bankruptcy is real and must be considered by debtors and their attorneys prior to the filing of petitions in bankruptcy.

163. See note 89 and accompanying text supra.
164. See note 80 and accompanying text supra.
165. See FED. R. BANKR. PROC. 403 for the procedures used in disallowing exemption claims. See COLLIER, supra note 41, ¶¶ 6.18 to -.22.
166. See note 125 and accompanying text supra. Section 67(d) (6) of the Bankruptcy Act provides that: "[A] transfer made or an obligation incurred by a debtor adjudged a bankrupt under this title, which is fraudulent under this subdivision d against creditors of such debtor having claims provable under this title, shall be null and void against the trustee. . . ." 11 U.S.C. § 107(d)(6) (1970). Section 70(e)(1) of the Bankruptcy Act provides:
A transfer made or suffered or obligation incurred by a debtor adjudged a bankrupt under this title which, under any Federal or State law applicable thereto, is fraudulent as against or voidable for any other reason by any creditor of the debtor, having a claim provable under this Act, shall be null and void as against the trustee of such debtor.

167. 11 U.S.C. § 32(c) (1970); Bankruptcy Reform Act, Pub. L. No. 95-598, §§ 548(a), 544(a), 92 Stat. 2549 (to be codified in 11 U.S.C. §§ 548(a), 544(a)).
168. In re Adlman, 541 F.2d 999, 1006 n.11 (2d Cir. 1976). See Comment, 22 VILL. L. REV. 1042 (1976-77) for an analysis of the "actual intent" test used to determine objections to discharge under § 14(c) (4).
169. The debtor was denied a discharge in In re Schwingle, No. 77-855 (W.D. Wis., filed April 10, 1978). See notes 183-88 and accompanying text infra. Unsuccessful attempts to bar a discharge were made in In re Adlman, 541 F.2d 999 (2d Cir. 1976). See notes 170-77 and accompanying text infra; In re Silansky, 21 F. Supp. 41 (E.D. Pa. 1937); Forsberg v. Security State Bank, 15 F.2d 499 (8th Cir. 1926).
The danger of denial of a discharge of debts, the most important benefit gained in a bankruptcy proceeding, because of the conversion of nonexempt to exempt property on the eve of bankruptcy is illustrated by In re Adlman.\textsuperscript{170} There the debtor had sold her non-exempt home\textsuperscript{171} to relatives for the sum of one hundred and twenty-five thousand dollars, giving her sixty thousand dollars above the balance of the first mortgage. She then entered into a lease with the purchasers and continued to live in the house with her family. Simultaneously with the closing of title, the debtor paid off more than fifty thousand dollars of loans outstanding on exempt life insurance policies on the lives of her husband and her father and paid more than seven thousand dollars in premiums on those policies, prepaying some of these premiums prior to the due dates.\textsuperscript{172} The debtor testified that she made the payments because her husband was in poor health and she was concerned that she might be unable to obtain other insurance if those policies lapsed. Approximately five and one-half months after payment of the loans and premiums, the debtor filed a voluntary petition in bankruptcy, declaring liabilities in excess of four million dollars and no assets other than life insurance policies having a face value of two hundred seventy-five thousand dollars, which she claimed as exempt.

One creditor sought to bar the debtor's discharge on the ground that the payments to the insurance company constituted transfers made with intent to defraud her creditors.\textsuperscript{173} The bankruptcy judge denied the discharge, finding that it was the debtor's "intention to remove such funds from the reach of her creditors by placing the same in an exempt category."\textsuperscript{174} The district court affirmed on the ground that fraudulent intent could be inferred from the sale of the house, the repayment of insurance loans, and the premium payments. By a two-to-one margin, the Second Circuit reversed the denial of discharge. The court held that the evidence indicated only constructive fraud, not actual fraud, in that there was an absence of extrinsic fraud apart from the payments themselves.

Although the bankrupt ultimately received a discharge of her debts, debtors can take little comfort from the Adlman decision. The Adlman court was careful to limit the holding to the specific facts of

\textsuperscript{170} 541 F.2d 999 (2d Cir. 1976).
\textsuperscript{171} At the time of the sale, the New York homestead exemption was limited to $2,000 and applied only if the debtor filed a declaration prior to incurring the debts owned on the date of bankruptcy. The declaration requirement was eliminated and the exemption was increased to $10,000 in 1977. N.Y. CIV. PRACT. LAW § 5206 (McKinney 1978).
\textsuperscript{172} The insurance policies were exempt under N.Y. INS. LAW § 166 (McKinney 1966).
\textsuperscript{174} In re Adlman, 541 F.2d 999, 1002-03 (2nd Cir. 1976).
the case before it. Also, the dissent emphasized that whether the bankrupt acted with the intent to defraud was "a purely factual question" involving a "question of motive." The decision teaches that an insolvent debtor who improperly acquires exempt property prior to bankruptcy must consider seriously the risk of the denial of a discharge, as well as the risk of the loss of the exemption.

V. PLANNING FOR BANKRUPTCY: THE CHILLING EFFECT ON THE DEBTOR'S COUNSEL

In view of the case law indicating that a debtor will be permitted to take advantage of exemption laws by converting nonexempt to exempt property in contemplation of bankruptcy, it could be argued that a debtor's attorney has a duty to advise his client of the available exemptions in the jurisdiction and to encourage the debtor to acquire exempt assets reasonably related to the needs of the debtor or his family. So long as his purpose is to obtain a reasonable amount of property to fulfill his genuine needs, such acquisitions can be considered as part of the debtor's prudent planning. The attorney must be careful, however, to avoid counseling a fraudulent transaction, such as acquiring assets on credit without intending to make payment.

Judicial treatment of this issue has made it extremely difficult for the debtor's lawyer to give specific and complete advice to his client. Lack of uniformity and use by some courts of the nebulous purpose test to determine the nature of the debtor's conduct hampers the attorney's ability to predict with certainty when actual fraud relating to a particular conversion of nonexempt to exempt property will be found. When uncertainty is combined with the risk that a court might deprive the debtor of a discharge of his debts, the result is a chilling effect on the debtor's counsel in advising his client. A cautious lawyer might be reluctant to advise a debtor to purchase exempt property even when the purchase is justified by the debtor's genuine need for the property. On the other hand, a lawyer who does advise

175. "We only determine that the acts performed by the bankrupt housewife in this case were not of a sufficiently fraudulent character to bar her discharge." Id. at 1006 (emphasis added).
176. Id.
177. Id. at 1007.
178. ABA CODE OF PROFESSIONAL RESPONSIBILITY, Disciplinary rule 7-102 (a) (1976) provides in pertinent part: "In his representation of a client, a lawyer shall not: ... (7) Counsel or assist his client in conduct that the lawyer knows to be illegal or fraudulent."
179. See notes 131-35 and accompanying text supra.
180. Lack of uniformity can be attributed to the treatment of this issue as a matter of state law. See note 102 and accompanying text supra.
181. See notes 144-64 and accompanying text supra.
182. See notes 167-77 and accompanying text supra.
a debtor to acquire exempt property might expose his client to serious risks.

In re Schwingle, în a recent decision by a bankruptcy judge, illustrates the problems confronting the lawyer who is asked to advise a debtor on the conversion of nonexempt to exempt property prior to bankruptcy. The debtor, a seventy-nine-year-old widow, resided on a farm of one hundred thirty acres. In 1974, she had sold the farm to her two sons, reserving a life estate in the home located on the farm. The sons had given her a promissory note, secured by a mortgage on the farm, for the purchase price of thirty-three thousand dollars.

Subsequent to the sale, as a result of an automobile accident, the widow became insolvent and owed at least one hundred twelve thousand dollars to creditors. She consulted her lawyer regarding her concern that her assets would be levied upon. The lawyer suggested various ways to preserve her assets from the reach of creditors. Among other alternatives, he suggested that the sons resell the farmhouse to the debtor in satisfaction of their obligation to pay the balance on the promissory note, after which the debtor would file a bankruptcy petition and declare the house an exempt homestead. This transaction would preserve the debtor’s assets by converting the nonexempt right to receive payment from the sons into the exempt homestead. Although the debtor in any case would have been entitled to keep a life estate in the house free of creditors’ claims, this transfer would have permitted her to keep the fee as well.

Prior to the resale of the house to the debtor, her attorney researched the question of the propriety of converting nonexempt to exempt assets, advising the debtor that it was his opinion “that such an action on your part is perfectly proper.” He warned the debtor, however, that such a transfer likely would result in legal action against the debtor “in an effort to upset [her] repurchase of the homestead,” and he accurately concluded that “only the judge will tell us if in fact [this action] was proper.”

183. No. 77-855 (W.D. Wis., filed April 10, 1978).
184. Id. at 7.
185. Id.
186. Id. The attorney’s advice was contained in the following letters:

Dear Mrs. Schwingle:

As I told you folks on 5-17-77, I’d prepare a letter setting forth what, if anything, you could do to preserve as much of your assets as possible from collection by the [creditors].

The Uniform Fraudulent Conveyance Act found in Chapter 242 of the Wisconsin Statutes protects creditors . . . . Therefore you won’t be allowed to give away your assets. It also could present a problem on the purchase of a homestead because you’d be using some non-exempt property (that portion of the mortgage note still
At the debtor's request and after warning of a possible legal challenge, the lawyer arranged for the repurchase of the house and the filing of a voluntary bankruptcy petition. This sequence of transactions, however, resulted in the denial of a discharge. The bankruptcy judge held that the only purpose of the transfer was to put the debtor's assets beyond the reach of her creditors and emphasized that she already had the right to live in the house because her life estate was exempt under Wisconsin law. This factor proved that her motive was not to acquire a home, but to protect the payments to be made to her by her sons.

In cases in which a debtor pays off a mortgage on a homestead, transfers such as the one involved in Schwingle are often upheld as proper, making it difficult to have predicted accurately the result in that case. Based on Schwingle, however, it would now appear that, whenever a conversion of nonexempt to exempt property by an insol-
vent debtor contemplating bankruptcy does not give the debtor the use of newly acquired property, the court may find that the only purpose of the conversion was to put assets out of the creditors' reach. Consequently, such a transfer would constitute actual fraud sufficient to bar a discharge.

As a result of such cases as *Schwingle*, lawyers might become reluctant to help debtors plan for bankruptcy by advising the conversion of nonexempt to exempt property. At the very least, *Schwingle* demonstrates the importance of advising debtors that a denial of discharge might result if the lawyer is wrong in predicting that a particular acquisition of exempt property is free from actual fraud.

V. RECOMMENDATIONS

It is consistent with most of the modern justifications for exemption laws to permit a debtor to acquire exempt assets in contemplation of bankruptcy.190 Allowing exemptions for such property is also consistent with the federal bankruptcy policy of affording the debtor a fresh start in life.191 Property necessary for the physical and financial survival of the debtor and his family, as well as property necessary for the debtor's dignity and his moral, religious, and cultural identity, should be available to him regardless of his financial condition when he acquired these essential items. The policies behind exemption laws must be balanced, however, against the possibility of abuse of the laws, which would unfairly burden creditors and permit the debtor to keep property unrelated to his actual needs. Judicial approval of conversions of nonexempt to exempt property prior to bankruptcy, without regard for the amount of property acquired so long as there is an absence of extrinsic fraud, is unfair to creditors. Further, lawyers are handicapped in advising clients properly prior to bankruptcy because of the lack of uniformity among states,192 the inability to predict accurately a court's decision in a particular case, and the serious consequences of a possible fraud on creditors.193

The ideal solution to the problem of abuse would be to reevaluate and modernize state exemption laws, carefully defining the limits on the necessities that the debtor may keep and permitting debtors to acquire exempt property at any time and under any financial conditions. This solution would permit a debtor to plan for bankruptcy by acquiring property reasonably related to his actual needs and would avoid the problems of abuse. There is no reason to continue to have

190. See notes 30-76 and accompanying text *supra*.
191. See note 5 *supra*.
192. See notes 102, 180 and accompanying texts *supra*.
193. See notes 167-77 and accompanying text *supra*.
open-ended exemptions which allow a debtor to protect an excessively large portion of his estate by buying an unreasonable amount of otherwise necessary items.\textsuperscript{194} Calls for modernization of state exemption laws have been largely unheeded, however, and it is unrealistic to expect such changes in the near future.\textsuperscript{195} Creating appropriate federal exemptions to replace state exemptions in all bankruptcy cases would be another possible solution. The Bankruptcy Reform Act, however, continues to permit debtors who so desire to take advantage of existing state exemption laws.\textsuperscript{196} Nevertheless, conversion of nonexempt to exempt assets prior to bankruptcy should be governed by federal law. First, uniformity facilitates certainty and there is a serious need for certainty on this issue. Although analysis of the facts on a case-by-case basis may be necessary, debtors and their counsel should not have to guess what standards a court will apply when ruling on the propriety of the acquisition of exempt property. Clarity is especially important because of the serious danger of unwittingly crossing the murky line that separates prudent planning for bankruptcy from actual fraud.\textsuperscript{197} It is unfair to deprive a debtor of a discharge of debts when he is unable to determine in advance whether his conduct will be judged proper.

Another reason for treating this issue as a federal question is that, in order to arrive at a rational approach, bankruptcy courts should be permitted to give appropriate weight to the purposes and policies behind the federal bankruptcy laws.\textsuperscript{198} Under the present system, federal bankruptcy courts rely on state court decisions which do not always deal with debtors who actually file bankruptcy petitions. Instead, those decisions deal solely with situations in which debtors transformed nonexempt to exempt property either while insolvent or

\textsuperscript{194} See notes 88-90 and accompanying text supra.
\textsuperscript{195} In the last 70 years, few state legislatures have considered the issue of debtor exemption laws. When new exemptions have been enacted, it has been in a piecemeal fashion and without consideration of the entire scheme of exemptions. State legislatures must reconsider their exemption laws in their entirety, repeal obsolete exemptions, and remove exemptions which reflect the interests supported by lobbyists rather than those of debtors and creditors.
Vukowich, supra note 3, at 877-78. See Joslin, supra note 65; 53 C\textsc{ornell} L. Rev., supra note 9; 68 Y\textsc{ale} L. J., supra note 2; Note, Debtor Exemptions in Personal Property—Proposals for Modernization, 52 Ky. L. J. 456 (1964).


\textsuperscript{196} See note 17 and accompanying text supra.

\textsuperscript{197} "If the conclusion remains that some types of conduct should result in exemption forfeiture, that conduct should be more clearly defined than it now is." Countryman, supra note 10, at 748.

\textsuperscript{198} See note 5 supra.
with the intent to defeat creditors who were using or threatening to use state collection remedies. 199 It is inappropriate for bankruptcy courts to rely on such cases for authority on the purchase of exempt property in contemplation of a bankruptcy, a subject significantly different from purchasing exemptions for the purpose of insulating assets from state collection remedies. 200 When a debtor purchases exemptions in contemplation of bankruptcy, he attempts to deprive creditors permanently of the ability to effectuate collection in that his debts will be discharged. When a debtor increases his exemptions at a time when creditors are pursuing state remedies, however, the creditors might only be temporarily delayed in recovering payment until the debtor acquires nonexempt assets. For example, a debtor who converts all of his nonexempt property into an exempt life insurance policy or homestead will not escape a wage garnishment on future income or a levy on other nonexempt assets acquired in the future. But a debtor who makes the same conversion of his property, and then files a bankruptcy petition, will be able to earn future income and acquire nonexempt assets free from claims discharged in bankruptcy. Thus, it is a more serious deprivation of creditors' rights to sanction the purchase of exempt property when the debtor files or intends to file a bankruptcy petition. On the other hand, it can be argued that the federal policy of affording the debtor a fresh start following bankruptcy by permitting him to keep exempt property is so important that it should apply whether or not the property is purchased in contemplation of bankruptcy. That policy should supersede state court decisions which deny exemptions purchased by insolvent debtors with the intention of maximizing the benefits of state exemption laws. For these reasons, it would be advisable for bankruptcy courts to apply uniform federal standards for recognition of exemptions purchased on the eve of bankruptcy, which give appropriate weight to the subsequent discharge of debts and to the federal policy of giving the debtor a fresh start. 201

200. "State exemption laws are not designed primarily for use in a system of orderly liquidation where all of the debtor's estate is to be converted to cash, but in a system of piecemeal liquidation where each creditor levies upon and sells such property as he can locate." Countryman, supra note 10, at 681.
201. The National Bankruptcy Conference disagreed with the approach of creating a federal policy to deal with the problem of acquiring exempt property on the eve of bankruptcy. In 1958, the Conference had adopted a resolution calling for federal legislation that would make the purchase of exempt property with nonexempt funds and the conversion of nonexempt property into exempt property a fraudulent transfer on the eve of bankruptcy, and a possible bar to a discharge in bankruptcy, with a homestead exception. In 1959, the Conference rescinded the resolution because it was considered "an unwise federal interference with the availability of exemptions provided by state law for improvident debtors." Kennedy, supra note
Recognition of state exemption laws in bankruptcy, subject to a uniform federal rule governing the acquisition or improvement of exempt property on the eve of bankruptcy, would not be a novel approach. Bankruptcy in the United States is characterized by a deliberate recognition of state property rights, as limited by federal principles designed to further dominant bankruptcy policies. For example, the present Bankruptcy Act recognizes and gives effect to judicial liens arising under state law except when such liens are obtained against an insolvent debtor on the eve of bankruptcy.\textsuperscript{202} State statutory liens are also generally recognized,\textsuperscript{203} but not when they first become effective upon the debtor's insolvency or liquidation.\textsuperscript{204} Although the present Bankruptcy Act defers to state law to determine what constitutes property of the debtor passing to the trustee,\textsuperscript{205} the United States Supreme Court has held that bankruptcy courts are not strictly bound by state definitions of "property" when the item in question is needed for the debtor's fresh start in life.\textsuperscript{206} In fact, both the present and the new Bankruptcy Acts expressly preempt state exemption laws when exempt property, fraudulently concealed or transferred, is

\textsuperscript{9} at 476. Professor Kennedy commented that the rescission reflected "... an appreciation of the difficulties of formulating a national solution for a problem exhibiting many aspects in the more than half a hundred different jurisdictions where the law must be applied." Id. at 481.


\textsuperscript{205} Section 70(a)(5) provides that the trustee shall be vested by operation of law with title to the bankrupt's nonexempt "property, including rights of action, which prior to the filing of the petition he could by any means have transferred or which might have been levied upon and sold under judicial processes against him, or otherwise seized, impounded, or sequestered . . . ." 11 U.S.C. § 110(a)(5) (1970).

Bankruptcy courts apply state law to determine whether property is transferable by the bankrupt or subject to judicial process. See 4A W. Collier, Bankruptcy, § 70.15 [2] (14th ed. 1975). In Segal v. Rochelle, 382 U.S. 375 (1966), the Supreme Court stated that "whether property could have been transferred by a bankrupt prior to the filing of the petition or was then subject to levy and sale under judicial process against him is generally a matter of local law."

\textsuperscript{206} The Supreme Court has said:

The most important consideration limiting the breadth of the definition of "property" lies in the basic purpose of the Bankruptcy Act to give the debtor a "new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt. The various provisions of the Bankruptcy Act were adopted in the light of that view and are to be construed when reasonably possible in harmony with it so as to effectuate the general purpose and policy of the act."

later recovered by the trustee.\textsuperscript{207} Congress, by providing for minimum federal exemptions as an alternative to state exemptions in the Bankruptcy Reform Act,\textsuperscript{208} balanced state exemption policies with the federal bankruptcy policy of assuring the debtor the opportunity for a meaningful fresh start. Therefore, it is consistent with the scheme of bankruptcy legislation and case law\textsuperscript{209} to adopt a uniform federal policy on allowance of exemptions acquired or improved on the eve of bankruptcy, while still generally permitting debtors to take advantage of state exemption laws. Further, because of the availability of federal bankruptcy exemptions under the Reform Act,\textsuperscript{210} bankruptcy courts will be required to treat the propriety of the purchase of such exempt property as a federal question.

Encouraging financially distressed debtors to plan for bankruptcy by permitting them to acquire or improve exempt property will prevent prejudice against those debtors who do not have the foresight to predict financial disaster or the sophistication to purchase their exemptions early.\textsuperscript{211} The items and quantity to which the debtor is entitled must be carefully limited, however, to prevent abuse and to protect the rights of creditors. The limitations imposed must depend on the particular needs and circumstances of the individual debtor. For example, an insolvent debtor might be justified in purchasing a

\textsuperscript{207} See notes 99-100 and accompanying text supra; See \textit{In re Myers}, 383 F. Supp. 251 (W.D. Mo. 1973); Comment, 41 Mo. L. Rev. 84 (1976).
\textsuperscript{208} See note 17 and accompanying text supra.
\textsuperscript{209} See notes 96-177 and accompanying text supra.
\textsuperscript{211} Most lawyers, and layman too, are offended by the spectacle of a man who, having some means but more debt, systematically canvasses the exemption statutes of his state, converts his leviable assets into the forms of property protected by those statutes, and then comes into the bankruptcy court for an award of his exemptions and of an order of discharge. It is understandable that a majority of the members of the National Bankruptcy Conference should resolve at a recent annual meeting that if such a thing is possible, as it appears to be, the law ought to be changed. \cite{Kennedy, supra note 9, at 477-78}. Professor Kennedy was referring to the resolution of the National Bankruptcy Conference adopted in 1958 and rescinded in 1959, discussed at note 201 supra. Professor Kennedy continued, however:

If the exemption idea is sound at all, however, it is stultifying to withhold exemptions from those whose need for their protection is the greatest because they did not have the foresight to get their quota of exemptions early. It is indefensible to take away a $1,000 homestead, or a $500 tractor needed for his work, exempted by a cautious state to the head of a large family, because he acquired his interest on the eve of bankruptcy, but to leave intact the mansion and Cadillac of a man and wife because acquired in time and in a state without a ceiling on the value of the homestead or exempt motor vehicle. A man of some sophistication can be expected to maneuver his dispositions with sufficient perspicacity to be prepared for bankruptcy when it eventually comes, if a sufficient premium is placed on advance preparations. A debtor of little forethought or aptitude in managing his affairs can be
reasonable number of new tools for his trade if his old tools are worn, whereas another probably would not be justified in buying a new Cadillac in order to work as an insurance salesman. In a third situation, it might be reasonable for a debtor to pay off a burdensome lien on an exempt automobile that he needs to travel to his employment. The bankruptcy judge should therefore have discretion to determine the reasonableness of each acquisition or improvement of exempt assets on the basis of the debtor's individual circumstances.

The need for certainty with regard to the propriety of acquiring exempt property prior to bankruptcy makes it appropriate for federal bankruptcy legislation to deal expressly with this issue. The recommendations in this article might be implemented by adding the following provision to section 522 of the Bankruptcy Reform Act:

(n). Notwithstanding any other provision of this section, the allowance to the debtor of exemptions which are acquired, improved, or increased in value as a result of a transfer of the debtor's nonexempt property while insolvent and within ninety days of the filing by or against him of the petition initiating a case under this Title shall not be permitted to the extent that such acquisition, improvement, or increase in value exceeds the reasonable needs of the debtor or his dependents.

This amendment to section 522 would not affect the question of the validity of exemptions acquired prior to the ninety-day period. It will be presumed that conversions of nonexempt to exempt property prior to the ninety-day period were not part of a deliberate scheme to plan the bankruptcy estate and, accordingly, those conversions would be governed by state or other federal law. The proposed amendment expected to neglect the taking of precautions for his family's financial security until desperate prospects force him to contemplate liquidation. While it is meet enough ordinarily for the law to encourage diligence and prudence, it is suggested that a restriction on the allowance of exemptions in bankruptcy to those acquired well before the filing of the petition puts an inordinate premium on advance planning for the eventuality and runs counter to the policy of American exemption laws.

*Id.* at 479-80.

212. See note 60 *supra*.

213. *Id.* Some states have allowed exemptions for automobiles as tools of trade. *See*, e.g., *Mick v. Coey*, 21 Ohio L. Abs. 646 (1936); *Kelly v. Degelau*, 244 Iowa 873, 58 N.W.2d 374 (1953). *See generally* *COLLIERS*, *supra* note 41, ¶ 6.14.

214. The 90-day period conforms to sections of the Bankruptcy Reform Act which use the 90-day period as an arbitrary limit on the event of bankruptcy. For example, under § 547(b), Bankruptcy Reform Act, Pub. L. No. 95-598, 92 Stat. 2549 (to be codified in 11 U.S.C. § 547(b)), preferences are voidable only if made within 90 days of bankruptcy. Similarly, set-offs of mutual debts are voidable if made within 90 days of bankruptcy under § 553(b), Bankruptcy Reform Act, Pub. L. No. 95-598, 92 Stat. 2549 (to be codified in 11 U.S.C. § 553(b)).

For a similar proposal suggesting the use of an arbitrary deadline for the purchase of exempt items, *see* 68 *YALE L. J.*, *supra* note 2, at 1481.
would give the debtor and his lawyer ample time to plan for the reasonable acquisition of needed exemptions and to file a bankruptcy petition within ninety days of such acquisitions, thereby precluding the influence of state or other federal law on the allowance of the exemptions. The ninety-day period will also allow creditors time to file an involuntary bankruptcy petition should the debtor default on his debts while making unreasonable purchases of exempt property.215

In order to remove the chilling effect on debtor's counsel resulting from the risk of losing the benefit of bankruptcy discharge, the conversion of nonexempt to exempt property should never be regarded as sufficiently fraudulent to deny discharge, regardless of the debtor's intent.216 The denial of the exemption itself is a sufficient sanction to protect creditors from abuse of exemption laws by debtors. This would be accomplished by adding the following provision to section 548 of the Bankruptcy Reform Act:217

(e). For the purposes of this section the acquisition, improvement, or increase in value of exempt property as a result of a transfer by the debtor while insolvent and in contemplation of bankruptcy shall not be deemed a transfer with intent to hinder, delay, or defraud any entity to which the debtor was or subsequently became indebted.

Removing the risk of losing a discharge and permitting the acquisition of exempt property to the extent it is reasonably related to the needs of the debtor and his family will free bankruptcy lawyers to engage actively in the proper planning of the debtor's estate, giving the debtor the full benefit of exemption laws and permitting advice on reasonable acquisitions.

The proposed amendment would not prevent the bankruptcy court from imposing other sanctions when the debtor is guilty of fraudulent conduct independent of the mere conversion of nonexempt to exempt property. For example, the court would still have the power to de-


216. To categorize a conversion of nonexempt funds into exempt property as a fraudulent transfer is a questionable legislative technique, even if such action is regarded as a fraud on creditors. The only transfer in the case is presumably for a fair exchange, and the fraud, if any, could be frustrated by denying the exemption without touching the transfer. If non-exempt property has been transferred by an insolvent debtor on the eve of bankruptcy for less than a fair equivalent amount of exempt property, a fraudulent transfer has surely occurred under the law as now written in § 67d(2) (a) of the act. Kennedy, supra note 9, at 479 n.145.

clare a debt nondischargeable if the debtor purchased exempt prop-
erty on credit without any intention of paying for it.\footnote{218}

VII. CONCLUSION

Debtors and their attorneys should be permitted, and even encour-
egaged, to plan actively for bankruptcy by acquiring or improving
exempt property which the debtor reasonably needs to make a fresh
start. The present law discourages such planning because it has pro-
duced uncertainty concerning the propriety of converting nonexempt
to exempt property in contemplation of bankruptcy and because it
threatens to impose severe sanctions in the event that the conversion
is declared improper. The mere possibility of a denial of a discharge
of debts is enough to chill efforts to make even modest acquisitions of
the most essential property.

The Bankruptcy Reform Act of 1978 is a major step toward the goal
of protecting individual debtors by providing minimum federal
exemptions as an alternative for those debtors who live in states with
overly restrictive exemption laws. Despite the confusion arising from
disparate judicial treatment, however, Congress ignored the question of
whether an insolvent debtor may use nonexempt assets to acquire or
improve exempt property on the eve of bankruptcy. The Bankruptcy
Reform Act continues to leave resolution of this question to the courts
without providing any legislative guidance. Congress failed even to
indicate the appropriate sanction to be imposed when a bankruptcy
court finds that a purchase is indeed improper. This failure is espe-
cially surprising because property that will be purchased on the eve
of any bankruptcy might be claimed by the debtor as exempt under the
newly created federal bankruptcy exemptions contained in the Reform
Act.

This article does not purport to suggest that absolute certainty and
uniformity of treatment can be attained simply by statutory change.
Balancing the rights of creditors against the needs of debtors to ac-
quire property necessary for a fresh start must be left to the courts
for factual analysis on a case-by-case basis. It is suggested, however,
that the Bankruptcy Reform Act be amended to establish a uniform
standard to guide the courts in reaching their decisions, based on the
reasonable needs of the debtor and his dependants. By enacting the
proposed amendment, Congress would give approval to debtors and
their attorneys who wish to plan actively for the conversion of non-
exempt to exempt property within reasonable limits.

Mere approval of reasonable purchases or improvements of exempt
property on the eve of bankruptcy may not suffice, however, to over-

\footnote{218. See notes 132-35 and accompanying text \textit{supra}.}
come the reluctance of debtors and their attorneys to plan such purchases or improvements. The indefiniteness of the reasonableness standard will continue to discourage conversion unless the possible penalty for exceeding the bounds of reasonableness is mitigated. Accordingly, this Article also recommends that the Bankruptcy Reform Act be amended so that even an unreasonable purchase of exempt property in contemplation of bankruptcy will not act to deprive the debtor of a discharge of his debts. A denial of the exemption when a purchase or improvement is found to have been unreasonable is sufficient to protect the interests of creditors and to deter abuse by debtors.