The Special Challenges of High Income Debtors
(Including the Means Test and Individual Chapter 11 Cases)

A. Circumstances of, and Preparation for, Filing High-End Debtor Cases

1. Common facts and circumstances

2. Assembling documents, use of tax returns to reconcile information, valuing assets on schedules

3. Client management (need to slow clients down, 341 testimony and transmittal of documents to trustee)

4. Reversing prepetition conveyances and related implications

In re Nino, 2008 Bankr. LEXIS 3845 (2008) (J. Dales) rev'd. *Nino v. Moyer,* 2009 U.S. Dist. LEXIS 12198 (2009) - Trustee objected to Debtor's exemption of entireties property where property, originally held as entireties, was transferred to nondebtor spouse and returned to entireties status just prior to filing. The Bankruptcy Court denied Debtor's exemption, rejecting the Debtor's claim that the property had been restored to its entireties condition with no harm to creditors. The Bankruptcy Court found that Debtor's individual creditors had a right to pursue any value the Debtor might have received when he transferred the property to his wife and because that value was eliminated when the property was placed back into the entireties, the creditors were harmed. The District Court reversed, finding no harm to creditors and affirming the continuing validity of the "no harm, no foul" rule under Michigan's fraudulent transfer act which excludes entireties property from the type of property that can be the subject of an avoidance action.

Tavenner v. Smoot, 257 F.3d 401 (4th Cir. 2001). Court considered whether a trustee can avoid a transfer of potentially exempt property. Debtor transferred his personal injury settlement funds to a corporation owned by members of his immediate family. The court noted that a majority of courts have rejected the "no harm no foul" rule. The majority of courts hold instead that all property, including potentially exempt property, is part of the bankruptcy estate. Thus, a transfer of potentially exempt property could harm creditors because it might not have actually been exempted. The court further reasoned that §522(g) is premised on the notion that a trustee can avoid and recover the transfer of exemptible property. All of the Debtor's property, including exemptible property, is

presumed to be part of the estate until the debtor claims exemptions. Creditors can be harmed by the transfer of exemptible property because it is never certain that the debtor will actually exempt such property from the estate. Thus, the "no harm no foul" approach is misguided; it is not a forgone conclusion that such property will be exempt from the estate and such rule is inconsistent with the bankruptcy code.

First Beverly Bank v. Adeeb (*In re Adeeb*), 787 F.2d 1339 (9th Cir. 1986). - Limited to involuntary petitions. Debtor transferred property to his friends and later reversed the transfers on advice from a bankruptcy attorney. The court concluded that since the Debtor revealed his transfers to his creditors and made a good faith effort to recover the property, he was entitled to a discharge.

Davis v. Davis (*In re Davis*), 911 F.2d 560 (11th Cir. 1990). Debtor transferred his interest in property to his wife. A creditor sued to avoid the transfer. Upon the advice of a bankruptcy attorney, the Debtor reversed the transfer and filed bankruptcy the next day. The Debtor stated that the transfer did not reduce the assets available to creditors. The court held that the creditor was harmed since it incurred fees to bring the action. The trustee was authorized to avoid the transfer.

Lasich v. Wickstrom (*In re Wickstrom*), 113 B.R. 339 (Bankr. W. D. Mich. 1990). Among other transfers, the Debtor transferred $20,000 from his workers' compensation settlement to his parents two months prior to the bankruptcy filing. Trustee sought to void the transfers. Debtor argued that the property would have been exempt if he had owned it when the petition was filed. The court rejected the" no harm no foul" rule and found that the Debtor lost his right to exempt the proceeds when he transferred the funds to his parents.

Trujillo v. Grimmett (In re Trujillo), 215 B.R. 200 (9th Cir. BAP 1997). Debtors argued that the transfers of property were not avoidable because no harm was incurred by the creditors since the property would have been exempt had it not been transferred. The court held this argument was contradicted by the Bankruptcy Code and that the transfers were fraudulent.

5. Renunciation of inheritance - Not fraudulent transfers if done prepetition and in accordance with legal requirements for disclaimer of interest. MCL 700.2900 *et. seq.* (even where settlor has died, if state law provides that disclaimer relates back). *See:*
●*Royal v. Sanford (In re Sanford)*, 369 B.R. 609 (10th Cir. BAP 2007).

●*Gaughan v. Edward Dittlof Revocable Trust (In re Costas)*, 346 B.R. 198 (9th Cir. BAP 2006).
●*Wood v. Bright (In re Bright)*, 241 B.R. 664 (9th Cir. BAP 1999)
●*Blackwell v. Lurie* (*In re Popkin & Stern*), 223 F.3d 764 (8th Cir. 2000)
●*Jones v. Atchison* (*In re Atchison*), 925 F.2d 209 (7th Cir. 1991)
●*In re Simpson*, 36 F.3d 450 (5th Cir. 1994)

May still be a problem under 727(a)(3), though. See:
●*Pher Partners v. Womble* (*In re Womble*), 289 B.R 836 (Bankr. N.D. Texas 2003).
●*In re Kloubec*, 247 B.R. 246 (Bankr. N.D. Iowa 2000) *aff'd* 268 B.R. 173 (2001)
●*Richardson v. Schoemperlen* (*In re Schoemperlen*), 332 B.R. 179 (Bankr. Ill. 2005)

6. Pre-Bankruptcy Planning, and Avoiding 727 actions

Common Examples:

a. suggesting that Debtor's parents convert will to discretionary or spendthrift trust to avoid § 541(a)(5)(A);
b. disclaimer of inheritance; and
c. converting joint or joint tenants with right of survivorship bank or stock account to entireties account.

"[J]udicial decisions on the issue vary greatly. The lack of a coherent body of law has resulted in decisions, often within the same circuit, that are difficult to reconcile . . . One observer aptly put it thus: 'Fraud in bankruptcy planning appears to enjoy the same precise definition as pornography—the federal courts know it when they see it.'" *In re Boudrot*, 287 B.R. 582, 585 (Bankr. W.D. Okla. 2002)

The term "transfer" is used in:

- § 548 "Fraudulent Transfers and Obligations"
- § 727(a)(2) "the debtor, with intent to hinder delay or defraud a creditor or an officer of the estate . . . has transferred . . . property of the debtor within one year before the date of the filing of the petition"

"Transfer" is defined in § 101, as follows:
(54) The term "transfer" means —
(A) the creation of a lien;
(B) the retention of title as a security interest;
(C) the foreclosure of a debtor's equity of

redemption; or
(D) each mode, direct or indirect, absolute or conditional, voluntary or involuntary, or disposing or parting with —
(I) property; or
(ii) an interest in property.

Note: "Transfers" are avoidable under state law, if made with the intent to hinder, delay or defraud, or if without reasonably equivalent value, while the transferor was insolvent. MCL 566.34. However, "asset" (typically the subject of a fraudulent transfer) by definition does not include "an interest in property held in tenancy by the entireties". MCL 566.31(b)(iii).

B. Chapter 7 vs. Chapter 11

1. When is Chapter 11 appropriate?

a. Who may be a debtor. 11 U.S.C. § 109(e).
b. The existence of non-exempt equity in real and/or personal property.
c. Means Test. Form 22A.
d. Restructuring of debtor/creditor relationships for a term in excess of five (5) years.
e. Trustee issues. 11 U.S.C. § 1104.
f. Control of property of the estate. 11 U.S.C. § 1107.

2. Commitment periods in Chapter 11 and funding.

a. 11 U.S.C. § 1129(a)(15)(B) provides that

"[t]he court shall confirm a plan only if...[i]n a case in which the debtor is an individual and in which the holder of an allowed unsecured claim objects to the confirmation of the plan –
(A) the value, as of the effective date of the plan, of the property to be distributed under the plan on account of such claims is not less than the amount of such claim; or
(B) the value of the property to be distributed under the plan is not less than the projected disposable income of the debtor (as defined in 1325(b)(2)) to be received during the 5-year period beginning on the date that the first payment is due under the plan, or during the period for which the plan provides payments, whichever is longer."

b. Disposable Income - “under 11 U.S.C. § 1325(b)(2), ‘disposable income’ is defined as ‘current monthly income received by the debtor...less amounts reasonably necessary to be expended — (A)(I) for maintenance or support of the debtor or a dependant of the debtor...’ 11 U.S.C. § 1325(b)(2). A Debtor’s ‘current monthly income’ (CMI), is calculated pursuant to § 101(10A) of the Bankruptcy Code. In that section, Congress prescribed a six-month look back period to determine the CMI of a debtor before filing bankruptcy; the look back period ends on ‘the last day of the calendar month immediately preceding the date of the commencement of the case...’ 11 U.S.C. § 101(10A)(A)(I).” *In re Gray,* 2009 Bankr. LEXIS (Bankr.N.D.W.VA. 2009).

c. Query, how does one calculate the commitment period for projected disposable income in an individual Chapter 11 case?

d. *In re Tegeder*, 369 B.R. 477 (Bankr.D.Neb. 2007).

e. *In re Rodemeier*, 374 B.R. 264 (Bankr. D. Kan. 2007).

3. Practical issues in representing closely held businesses and their principals in companion Chapter 11 cases.

a. Conflicts of Interest and Disinterestedness. 11 U.S.C. § 327; 11 U.S.C. § 329; F.R.Bankr.P. 2016.

b. Consolidation (Administrative and Substantive).

C. Exemption and Property of the Estate Issues

1. Constitutionality of Michigan Bankruptcy Exemption Statute and Exclusivity Issues

Vinson and Silver v Dakmak (In re Vinson), 347 BR 620 (ED Mich. 2006). District Court (J. Edmunds) reversed Bankruptcy Court finding that Michigan’s bankruptcy exemption statute was unconstitutional because MCL § 600.5451(1)(n) allowed a Debtor to claim an exemption in the property interest of a codebtor and the Debtor’s dependents.

In re Wallace, 347 BR 626 (Bkrtcy.W.D. Mich. 2006) (J. Hughes). 11 USC § 522(b)(2) did not authorize state to enact a customized set of bankruptcy exemptions, and Michigan bankruptcy exemption statute was

in violation of the Supremacy Clause.

2. Limitations On Equity in Real Property (11 USC § 522 (o), (p))

3. Property Located In Other States (*In re Nelms,*2005 Bankr. LEXIS 138 (Bkrtcy.E.D.Mich. 2005)(J. Shefferly), *see also, In re Gosnick,* 400 BR 582 (Bkrtcy.W.D.Mich. 2008)(J. Gregg) - exempting out of state property and the need to understand other states' exemptions and extraterritoriality issues. www.exemptionexpress.com

4. Cash surrender value in life insurance - MCL § 500.2207 (in or out)?

5. Entireties property, including stock and other evidences of indebtedness (MCL § 557.151) and the effect of Probert (*Zavradinos v. JRTB, Inc.,* 753 NW2d 60 (Mich. 2008)), and *In re Musilli,* Case No. 06-55963-SWR. Opinion dated March 13, 2009 (J. Rhodes)

6. LLC membership interests (MCL § 450.4504) as entireties property (in or out)?

7. Discretionary Trusts and Spendthrift Clauses

D. 727 Actions and Other Issues

1. 727 Actions - Implications of pre-bankruptcy exemption planning

In re Crater, 286 B.R. 756, 760 n.5 (Bankr. D. Ariz. 2002) - Reading 727(a)(2)(A) as a prohibition on prebankruptcy exemption planning 'would be contrary to the very purpose of providing exemptions, and because the ability to make intelligent use of the exemptions was specifically addressed and permitted by the legislative history of the Bankruptcy Code, which states that: "[D]ebtor will be permitted to convert nonexempt property into exempt property before filing of the bankruptcy petition. This practice *is not* fraudulent as to creditors, and permits [debtors] to make full use of the exemptions to which [they are] entitled under the law."' Notwithstanding, the court noted that a conversion of nonexempt assets into exempt assets can result in the denial of the discharge if there is extrinsic evidence of actual intent to defraud. The court then turned to an analysis of the badges of fraud.

First, the court separated the badges of fraud into three categories:

Category 1—Indicative of concealment, deception, or fraudulent intent: (i)

after the transfer, the debtor retained possession or control of the transferred property; (ii) the transfer was concealed; (iii) the debtor absconded; and (iv) the debtor removed or concealed assets;

Category 2—Transaction wasn't economically rational: (i) transfer was to an insider; (ii) consideration received was not reasonably equivalent to the value of the asset transferred; and (iii) debtor transferred the essential assets of a business to a secured party who transferred the assets to an insider of the debtor.

Category 3—Timing factors, not suspicious by themselves: (i) before the transfer, the debtor had been sued or threatened with suit; (ii) the transfer was of substantially all of the debtor's assets; (iii) the debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred; and (iv) the transfer occurred shortly before or shortly after a substantial debt was incurred.

Second, the court tentatively concluded that Category 2 and Category 3 badges of fraud—with the exception of insider status—are not sufficient evidence of actual fraud to compel a denial of discharge. That is, the Category 2 and Category 3 badges of fraud do not establish a *prima facie* case for denial of discharge, even when coupled with pre-bankruptcy exemption planning. Instead, those categories simply demonstrate that the debtor engaged in otherwise permissible exemption planning only when it became apparent that it would be intelligent to do so, and when debtor was willing to sacrifice some asset values to achieve the exemptions.

Third, the court compared its conclusion against the leading Circuit Court decisions (none of which are Sixth Circuit decisions). With the exception of Eighth Circuit authority, the court found that its approach was consistent with the various Circuit Court decisions (the court noted that the Eighth Circuit seems to hold that it is sufficient to deny discharge if the amount converted into exempt assets is "too much", or if the investment in exempt assets was unwise, uneconomical, or unusual from the debtor's perspective. The *Crater* Court simply disagreed with the Eighth Circuit's decisions.)

As a result of its analysis, the court concluded that a party seeking to deny discharge based on conversion of non-exempt assets to exempt assets must show: (i) a deception or concealment; (ii) an insider transaction; (iii) a fraudulent conveyance; (iv) a secretly retained possession or benefit; or (v) debtor explanations that lack credibility. Otherwise, the Category 2 and Category 3 badges of fraud are not sufficient to shift to the debtor the

burden of going forward, even if all of the debtor's nonexempt assets were converted into exempt assets just after being sued and just before filing bankruptcy.

See also, *In re Warren*, 512 F.3d 1241, 1249 (10th Cir. 2008); *In re Jennings*, 533 F.3d 1333, 1339 (11th Cir. 2008); *In re Smith,* Case No. 2:07-cv-101-FtM-34, Bankr. No. 9:05-bk-13111-ALP, 2008 U.S. Dist. Lexis 31532, at *29–30 n.15 (M.D. Fla. Mar. 31, 2008) (Though not specifically following *Crater*, denying discharge where Category 1 criteria present, and noting that denial of discharge was consistent with *Crater*); *In re Lee*, 309 B.R. 468 (Bankr. W.D. Tex. 2004) (endorsing *Crater* approach).

2. IRS Liens on ERISA-qualified Retirement Investments

   Under both the Internal Revenue Code and the Mandatory Victims Restitution Act of 1996 ("MVRA"), the government may use either federal or state law to enforce a tax lien and/or a judgment that imposes a fine or restitution. According to majority authority, to satisfy the obligation, the government may execute against ERISA-qualified retirement accounts. *U.S. v. Novak*, 476 F.3d 1041 (9th Cir. 2007) (en banc).

3. ERISA qualified plans with limited participants. *See, Yates v Hendon (In re Yates),* 541 U.S. 1; 124 S. Ct. 1330; 158 L. Ed. 2d 40 (2004). ERISA's antialienation provisions do not apply unless plan covers one or more employees other than business owner and spouse.

4. LLCs - Common vehicle used to shield assets. Debtor's interest is clearly property of the estate, and can be administered for the benefit of creditors, but restrictions on transfer and Michigan's LLC statute make value questionable, as assignment without consent of all members only transfers the right to receive distributions and not the right to vote or otherwise participate in decisions of LLC.