

ASSET PROTECTION PITFALLS FOR PROFESSIONALS

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The first question for any professional consulted for asset planning advice is whether the client is a risk for financial distress or insolvency. This article will assume that the client faces those risks, and will identify criminal, ethical and other issues that professionals should be aware of when counseling clients regarding asset protection.

In any insolvency proceeding, the debtor and the debtor's professionals are faced with competing (but not necessarily conflicting) interests: the need to preserve assets required by the debtor versus the need to deal fairly with creditors' interests in those assets. In order to successfully protect assets – that is to place assets where, with full disclosure of the circumstances, creditors' challenges to the placement of those assets fail – the debtor and the debtor's professional must walk a fine line between these competing interests. Stray too far from the line and the debtor (and sometimes the debtor's professional) may suffer the loss of the assets, civil and even criminal penalties. Bankruptcy, in particular, requires a debtor to come to court with clean hands with respect to pre-bankruptcy planning. A problem for the debtor's professional is that, short of intentional fraud, there are few clear guidelines to assist a professional in providing asset protection advice. The rules are applied differently from court to court and from judge to judge within those courts. Given that the debtor is either insolvent or facing financial distress, the professional should assume that a bankruptcy filing is likely.

The primary pitfalls a professional may face in providing asset protection advice are reviewed below. Some basic strategies to avoid the pitfalls are included at the end of the article.

A. Bankruptcy Crimes

Bankruptcy crimes are set forth in Chapter 9 of Title 18 of the United States Code (18 U.S.C. §§ 152 – 158).¹ Two sections of Title 18, Sections 152 and 157, have direct implications on pre-bankruptcy planning.

Section 152 of Title 18, titled “Concealment of assets; false oaths and claims; bribery,” makes it a crime to, among other things, knowingly and fraudulently conceal estate assets, make false statements in relation to a case under Title 11, or transfer or conceal property in contemplation of a case under Title 11. *See* 18 U.S.C. § 152.

Section 157 of Title 18, titled “Bankruptcy Fraud,” states as follows:

A person who, having devised or intending to devise a scheme or artifice to defraud and for the purpose of executing or concealing such a scheme or artifice or attempting to do so –

- (1) files a petition under title 11, including a fraudulent involuntary bankruptcy petition under Section 303 of such title;
- (2) files a document in a proceeding under title 11, including a fraudulent involuntary bankruptcy petition under Section 303 of such title; or
- (3) makes a false or fraudulent representation, claim, or promise concerning or in relation to a proceeding under title 11, including a fraudulent involuntary bankruptcy petition under Section 303 of such title, at any time before or after the filing of the petition, or in relation to a proceeding falsely assert to be pending under such title,

shall be fined under this title, imprisoned not more than 5 years, or both.

18 U.S.C. § 157.

These sections of Title 18 clearly cover pre-petition conduct and are therefore implicated in asset protection and pre-bankruptcy planning. The language in Sections 152 and 157 is very broad and is open to differing interpretations. Criminal intent, an element that must be

¹ Conduct in a bankruptcy proceeding may also violate other Federal criminal statutes. *See, e.g., United States v. Kubick*, 205 F.3d 1117 (9th Cir. 1999)(In conjunction with bankruptcy fraud, debtor and attorney also found guilty of conspiracy to impede Internal Revenue Service).

established under Section 152 and Section 157,² is frequently established by circumstantial evidence. *See United States v. Shapiro*, 101 F.2d 375, 377 (7th Cir. 1939)(criminal concealment of assets from bankruptcy trustee “is perpetrated in secrecy and is not readily proved by direct testimony and it is often necessary to prove the crime by circumstantial evidence.”). The necessary reliance on circumstantial evidence can lead to broad definitions of criminal conduct. *See, e.g., United States v. Grant*, 971 F.2d 799 (1st Cir. 1992)(debtor’s failure to describe assets in detail was evidence of effort to conceal true value of assets from trustee); *United States v. Defazio*, 899 F.2d 626 (7th Cir. 1990)(defendant could not claim that he had no knowledge where his ignorance resulted from deliberate choice not to organize his records); *United States v. Ramsey*, 785 F.2d 184, 189 (7th Cir. 1986)(“No person can intentionally avoid knowledge [of a crime] by closing his or her eyes to facts which should prompt him or her to investigate”).

Inferring intent from circumstantial evidence is a subjective process. This subjective process is exacerbated by the breadth of the language in Sections 152 and 157 of Title 18. Where a third party is reviewing conduct with the benefit of hindsight, even sloppy record keeping by a debtor or the debtor’s professional in pre-bankruptcy asset protection planning may lead to allegations of criminal conduct under Sections 152 or 157 of Title 18. For attorneys, conviction of a bankruptcy crime generally leads to disbarment. *See, e.g., In re Knoll*, 505 U.S. 1242, 118 S.Ct. 17 (1992)(attorney disbarred following conviction of aiding and abetting financial fraud); *In re Pfingst*, 385 N.Y.S.2d 806 (2nd Dep’t 1976)(attorney disbarred after conviction under 18 U.S.C. § 152).

Two decisions of note are *United States v. Trapilo*, 130 F.3d 547 (2nd Cir. 1997), and *United States v. Boots*, 80 F.3d 580 (1st Cir. 1996). In *Trapilo*, the Second Circuit Court of

² Although Section 157 does not contain an explicit requirement of intent, courts have interpreted Section 157 to require a specific intent to defraud. *See In re Milwitt*, 475 F.3d 1150 (9th Cir. 2007); *United States v. Wagner*, 382 F.3d 598 (6th Cir. 2006).

Appeals upheld convictions under the United States wire fraud statutes for a scheme to defraud the Canadian government of tax revenue. *Id.* The *Trapilo* Court held that the scheme to defraud was the conduct prosecuted, and the fact that a foreign entity was the victim was irrelevant to the fact that the conduct violated the wire fraud statute. *Id.* The *Boots* decision, under similar facts, contradicts the decision in *Trapilo*.³ See *Boots*, 80 F.3d 580. In *Boots*, the First Circuit Court of Appeals held that in order to convict under the United States wire fraud statutes, the Court would have to find an intent to violate Canadian law, and that therefore schemes to defraud foreign entities are not schemes within the meaning of the United States wire fraud statutes. *Id.* While this conflict between the First and Second Circuits has not been resolved by the Supreme Court, professionals who engage in asset protection for foreign entities must take into account that violations of foreign laws may subject the client (and possibly the professional) to prosecution under United States law.⁴

In practice, reported decisions involving professionals convicted of bankruptcy crimes generally deal with situations where the professionals were active participants in the crime. See *In re Knoll*, 505 U.S. 1242, 118 S.Ct. 17; *Kubick*, 205 F.3d 1117; *United States v. Rosen*, 130 F.3d 5 (1st Cir. 1997)(attorney active participant in scheme to divert estate assets). While this may provide some comfort to professionals, it provides none to their clients who may end up convicted of a crime. Moreover, it does not mean that an attorney will not face ethics problems, which is the next topic of discussion.

³ The Fourth Circuit Court of Appeals in *United States v. Pasquantino*, 336 F.3d 321 (4th Cir. 2003), sided with the Second Circuit's *Trapilo* decision.

⁴ A number of states, including Rhode Island and Delaware, have enacted so-called Domestic Asset Protection Trust statutes. These statutes, passed with the intention of attracting money to the states, permit, with some exceptions, the formation of trusts that protect assets from the settlor's creditors while at the same time permitting the settlor to be named as a beneficiary. Given the globalization of financial markets, these trusts undoubtedly attract investment from outside the United States.

B. Rules of Ethics

Knowledge of the rules of professional conduct is a must for attorneys providing asset protection advice and/or pre-bankruptcy planning. Model Rule of Professional Conduct⁵ 1.2(d) provides that:

A lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent, but a lawyer may discuss the legal consequences of any proposed course of conduct with a client and may counsel or assist a client to make a good faith effort to determine the validity, scope, meaning or application of the law.

MODEL RULE OF PROFESSIONAL CONDUCT Rule 1.2(d) (2009).

The comments to Model Rule 1.2(d) advise that an attorney is prohibited from assisting a client to commit a crime, but that the attorney may advise the client about the actual consequences of the client's conduct. *Id.*, cmt. [9]. The fact that a client uses the attorney's advice to commit a crime does not implicate the attorney in the crime. *Id.* If an attorney discovers that the client is conducting a course of fraudulent conduct, the attorney must avoid assisting the client and may be required to withdraw from the representation if the client continues the conduct. *Id.* cmt. [10]. In some instances, disclosure of the conduct may be required. *Id.*

Model Rule 1.6 prohibits an attorney from disclosing confidential information except where the attorney "reasonably believes" the disclosure is necessary:

- "[T]o prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services." MODEL RULE OF PROFESSIONAL CONDUCT Rule 1.6(b)(2) (2009).
- "[T]o prevent, mitigate or rectify substantial injury to the financial interests or property of another that is reasonably certain to result or has resulted from the

⁵ The Rules of Professional Conduct for Maine, Massachusetts, New Hampshire and Rhode Island are based on the Model Rules of Professional Conduct (the "Model Rules"). Accordingly, the Model Rules will be utilized in this article. Since the Rules of Professional Conduct in the aforementioned jurisdictions do contain changes to the Model Rules, attorneys should consult the Rules of Professional Conduct in their home jurisdiction.

client's commission of a crime or fraud in furtherance of which the client has used the lawyer's services." MODEL RULE OF PROFESSIONAL CONDUCT Rule 1.6(b)(3) (2009).

- "[T]o comply with other law or a court order." MODEL RULE OF PROFESSIONAL CONDUCT Rule 1.6(b)(6) (2009).

The comment relating to Model Rule 1.6(b)(6) advises that "[o]ther law may require that a lawyer disclose information about a client. Whether such a law supersedes Rule 1.6 is beyond the scope of these Rules." *Id.* cmt. [12]. The Bankruptcy Code, which imposes obligations on attorneys representing estate fiduciaries, may or may not qualify as such a law. The Model Rules provide little guidance in this respect.

Model Rules 3.3 ("Candor Toward The Tribunal") and 4.1 ("Truthfulness in Statements to Others") may also require disclosure of confidential information to courts and to third parties, respectively. *See* MODEL RULE OF PROFESSIONAL CONDUCT Rules 3.3, 4.1 (2009). Both of these rules impose a duty to refrain from making materially false statements to courts and third parties. *Id.*⁶

There is a paucity of guidance available to aid in the interpretation of the rules of ethics as they apply to asset protection planning. Asset protection and pre-bankruptcy planning, involving as they usually do some transfer of an interest in property, frequently implicate ethical rules. Attorneys must be careful not to cross an ethical line. Many states' ethical oversight bodies (Massachusetts, for one) have hotlines or methods of making anonymous inquiries. If in doubt, some effort should be made to resolve any ethical questions before providing asset protection or pre-bankruptcy planning.

⁶ The Model Rules and comments discussed in this article are attached as Appendix A.

C. Bankruptcy Pitfalls.

Actions taken to protect a client's assets will have a significant impact on any bankruptcy proceedings subsequently filed by the client. If the asset protection planning is done correctly, the impact will be positive for the client. If not, the impact may have serious consequences for the client, including loss of the bankruptcy discharge and criminal prosecution. The following are cases illustrative of some of the potential negative impacts.

- Denial of bankruptcy discharge for pre-petition conversion of non-exempt assets into exempt assets:

In re Segal, 227 B.R. 191 (Bankr. S.D. Fla. 1998)(debtors denied discharge for pre-petition use of non-exempt cash to purchase home subject to homestead exemption);

In re Kulwin, 187 B.R. 341 (Bankr. D. Kan. 1995)(conversion of non-exempt assets to exempt assets done with intent to hinder, delay or defraud creditor warranted denial of discharge);

In re Wojtala, 113 B.R. 332 (Bankr. E.D. Mich. 1990)(fact that debtor received fair value for assets transferred to family members does not prevent denial of discharge where transfer was done with intent to hinder, delay or defraud creditor);

In re Krantz, 97 B.R. 514 (Bankr. N.D. Iowa 1989)(debtors' conversion of non-exempt property into exempt insurance policies rose to level requiring denial of discharge);

But see *In re Johnson*, 938 F.2d 1073 (10th Cir. 1991)(conversion of non-exempt assets to exempt assets does not, without intent to defraud, give rise to denial of discharge); *In re Wadley*, 263 B.R. 857, 859 (Bankr. S.D. Ohio 2001)(general rule is that "the mere conversion of non-exempt assets into exempt assets does not, by itself, establish fraud").

- Pre-petition re-transfer of property fraudulently conveyed does not save discharge:

In re Davis, 911 F.2d 560 (11th Cir. 1990)(discharge denied on account of fraudulent conveyance of property even though property was re-transferred to the debtor pre-petition);

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In re Paulding, 370 B.R. 11 (Bankr. D. Mass. 2007)(absent compelling evidence that debtor “received ill-advice from counsel” when property was initially fraudulently transferred, re-transfer of property prior to petition date does not cleanse fraudulent transfer for discharge purposes);

But see *In re Adeeb*, 787 F.2d 1339 (9th Cir. 1986)(denial of discharge for fraudulent conveyance of assets not warranted where debtor sought to re-transfer assets prior to petition date).

- Post-petition re-transfer of property fraudulently conveyed does not save discharge:

In re Bajgar, 104 F.3d 495 (1st Cir. 1997)(post-petition re-transfer of property fraudulently conveyed pre-petition was insufficient to permit discharge to enter).

- Loss of exemption for pre-petition conversion of non-exempt assets into exempt assets:

In re Mueller, 867 F.2d 568 (10th Cir. 1989)(exemption of life insurance policy denied where policy purchased with non-exempt assets on eve of bankruptcy).

- Pre-petition conversion of non-exempt assets into exempt assets may constitute a transfer for purposes of avoidance under fraudulent transfer statutes:

In re Levine, 134 F.3d 1046 (11th Cir. 1998)(debtor’s purchase of exempt annuity with non-exempt funds constituted transfer within meaning of state fraudulent transfer laws).

But see *In re Messia*, 184 B.R. 176 (Bankr. D. Mass. 1995)(declaration of homestead does not constitute transfer); *In re Van Rye*, 179 B.R. 375 (Bankr. D. Mass. 1995)(same);

But see *In re Meyer*, 244 F.3d 352 (4th Cir. 2001)(use of non-exempt cash to pay down mortgage on exempt real estate is an avoidable transfer under state fraudulent conveyance law).

D. Strategies.

As demonstrated above, the line between providing good and bad asset protection and/or pre-bankruptcy planning advice can be difficult to discover, much less follow. Nevertheless, there are a few strategies that professionals can use to protect their clients and themselves.

Among these are the following:

1. Disclose Everything. Full disclosure is a requirement of the Bankruptcy Code. Even outside of bankruptcy, arriving at court with “clean hands” is a pre-requisite for success. If a debtor fully discloses his conduct to courts and to creditors, the chances of being accused of improper conduct will be reduced. *See In re Waddle*, 29 B.R. 100, 103 (Bankr. W.D. Ky. 1983)(“A debtor who fully discloses his property transactions at the first meeting of creditors is not fraudulently concealing property from his creditors.”); *see also In re Bajgar*, 104 F.3d at 501 (debtor who did not reveal fraudulent transfer until after petition date was not the honest debtor “that the Bankruptcy Code envisions as the deserving recipient of a fresh start.”). Moreover, full disclosure (within the applicable rules of ethics) will help the professional avoid ethical snarls.

2. Document Everything. Having a contemporaneous third-party appraisal to support the value of an asset at the time of its transfer can be of great use when the transfer is subsequently challenged. Likewise, a balance sheet or personal financial statement demonstrating that a debtor is solvent can be helpful. Since challenges to transfers of assets frequently do not take place for years after, documentation that is contemporaneous with the transfer can provide a substantial evidentiary advantage if the transfer is challenged. Documentation supportive of the merits of the transfer also provides protection from criticism (or worse) for the professional who counseled the debtor to make the transfer.



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3. Obtain Written Verification of Disclosure From The Client. Prior to making a transfer, professionals should consider obtaining written verification from the client that all pertinent facts surrounding the transfer have been disclosed.
4. Plan Ahead. The more time that passes between a transfer of assets and the challenge to that transfer, the better.

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