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PITFALLS OF PRE-BANKRUPTCY PLANNING: PRESERVING ASSETS *AND* THE DISCHARGE

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I. INTRODUCTION

The policy underlying the Bankruptcy Code is to provide honest debtors a "fresh start" while distributing to creditors a pro rata share of the proceeds which a trustee obtains after liquidating the nonexempt assets of the debtor's bankruptcy estate.[1] Individuals who file bankruptcy have two primary goals: 1) to obtain a discharge of financial obligations; and 2) to protect as many assets as

1. The Supreme Court described the policy 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 the bankruptcy*, a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of pre-existing debt.

Local Loan Co. v. Hunt, 292 U.S. 234, 244 (1934) (emphasis in original) (citation omitted).

possible from creditors by utilizing exemption statutes which allow debtors to retain certain assets.[2] Tension develops between the competing interests of the debtor and the debtor's creditors. The debtor desires to retain as many assets as possible from claims of creditors or the trustee appointed to liquidate assets in the bankruptcy proceedings. The creditors and the trustee seek to maximize assets in the estate and may object to a discharge if improper acts are believed to have occurred prior to bankruptcy or during the course of the case. A discharge in bankruptcy is a privilege and not a matter of right.[3] The denial of an individual's discharge after his or her assets have become property of the bankruptcy estate and subsequently liquidated for the benefit of creditors deprives a debtor of the benefits sought by filing bankruptcy.

One of a bankruptcy lawyer's most difficult tasks is to advise a client on exemption and asset planning prior to filing for bankruptcy.[4] Clients want direction and advice. A debtor-client who seeks direction from bankruptcy counsel finds little comfort in knowing that the Eighth Circuit recognizes "that separating ordinary pre-bankruptcy planning from fraudulent action is difficult."[5] Unfortunately, it is difficult to provide clients with bankruptcy planning advice which is absolute. Despite numerous attempts by courts to define the legal boundaries of pre-bankruptcy planning, and to further Congress' intent to give debtors a fresh start, few clear rules exist. Each case seems to present new and distinct factual situations that are difficult to analyze in a consistent manner with controlling authority and prior decisions.

A debtor-counsel's role is to advise clients of the benefits, risks and responsibilities associated with a bankruptcy proceeding and to develop an informed strategy in preparation for and the participation in the bankruptcy process. The purpose of this article is to provide counsel with suggestions on how to advise clients in light of the hodgepodge of judicial decisions on these issues. The article includes a summary of the statutory law and significant decisions

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2. *See id.*

3. *See* United States v. Kras, 409 U.S. 434, 447 (1973).

4. *See* Panuska v. Johnson (*In re* Johnson), 80 B.R. 953, 957 (Bankr. D. Minn. 1987). Bankruptcy estate planning was defined by the court as:

> the conscious, directed effort on the part of a financially-besieged debtor to liquidate personal assets which are not exempt from claims of general creditors under the state debtor-creditor law, and to use the proceeds of that liquidation to purchase, or pay down existing encumbrances on assets which are exempt under state law, as a preliminary to the debtor's claim of exemption in those assets in the subsequent bankruptcy case.

Id.

5. Panuska v. Johnson (*In re* Johnson), 880 F.2d 78, 81 (8th Cir. 1989).

which reveal factors considered by the courts as important in determining whether pre-bankruptcy conduct or actions taken during a bankruptcy case prevent a discharge in bankruptcy from being granted. Additionally, it will provide practical suggestions for counsel and debtor-clients to consider when preparing for bankruptcy and participating in the bankruptcy process, to enable them to accomplish the twin objectives of retaining assets *and* obtaining a discharge.

II. THE LAW

A. APPLICABLE STATUTES

1. *11 U.S.C. § 727—Discharge Section*

Section 727 of the Bankruptcy Code, which will be the principal focus of this article, sets forth those circumstances under which a Chapter 7 individual debtor will not be discharged of debts.[6] A

6. 11 U.S.C. § 727 (1988). Section 727 provides as follows:

(a) The court shall grant the debtor a discharge, unless—
- (1) the debtor is not an individual;
- (2) the debtor, with intent to hinder, delay, or defraud a creditor or an officer of the estate charged with custody of property under this title, has transferred, removed, destroyed, mutilated, or concealed, or has permitted to be transferred, removed, destroyed, mutilated, or concealed—
  - (A) property of the debtor, within one year before the date of the filing of the petition; or
  - (B) property of the estate, after the date of the filing of the petition;
- (3) the debtor has concealed, destroyed, mutilated, falsified, or failed to keep or preserve any recorded information, including books, documents, records, and papers, from which the debtor's financial condition or business transactions might be ascertained, unless such act or failure to act was justified under all of the circumstances of the case;
- (4) the debtor knowingly and fraudulently, in or in connection with the case—
  - (A) made a false oath or account;
  - (B) presented or used a false claim;
  - (C) gave, offered, received, or attempted to obtain money, property, or advantage, or a promise of money, property, or advantage, for acting or forbearing to act; or
  - (D) withheld from an officer of the estate entitled to possession under this title, any recorded information, including books, documents, records, and papers, relating to the debtor's property or financial affairs;
- (5) the debtor has failed to explain satisfactorily, before determination of denial of discharge under this paragraph, any loss of assets or deficiency of assets to meet the debtor's liabilities;
- (6) the debtor has refused, in the case—
  - (A) to obey any lawful order of the court, other than an order to respond to a material question or to testify;
  - (B) on the ground of privilege against self-incrimination, to respond to a material question approved by the court or to testify, after the debtor has been granted immunity with respect to the matter concerning which such privilege was invoked; or

"discharge" objection may be commenced by the trustee assigned to the case,[7] a creditor or the United States Trustee against an individual debtor under § 727. A successful objection to discharge

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(C) on a ground other than the properly invoked privilege against self-incrimination, to respond to a material question approved by the court or to testify;

(7) the debtor has committed any act specified in paragraph (2), (3), (4), (5), or (6) of this subsection, on or within one year before the date of the filing of the petition, or during the case, in connection with another case, under this title or under the Bankruptcy Act, concerning an insider;

(8) the debtor has been granted a discharge under this section, under section 1141 of this title, or under section 14, 371, or 476 of the Bankruptcy Act, in a case commenced within six years before the date of the filing of the petition;

(9) the debtor has been granted a discharge under section 1228 or 1328 of this title, or under section 660 or 661 of the Bankruptcy Act, in a case commenced within six years before the date of the filing of the petition, unless payments under the plan in such case totaled at least—

(A) 100 percent of the allowed unsecured claims in such case; or

(B)(i) 70 percent of such claims; and

(ii) the plan was proposed by the debtor in good faith, and was the debtor's best effort; or

(10) the court approves a written waiver of discharge executed by the debtor after the order for relief under this chapter.

(b) Except as provided in section 523 of this title, a discharge under subsection (a) of this section discharges the debtor from all debts that arose before the date of the order for relief under this chapter, and any liability on a claim that is determined under section 502 of this title as if such claim had arisen before the commencement of the case, whether or not a proof of claim based on any such debt or liability is filed under section 501 of this title, and whether or not a claim based on any such debt or liability is allowed under section 502 of this title.

(c) (1) The trustee, a creditor, or the United States trustee may object to the granting of a discharge under subsection (a) of this section.

(2) On request of a party in interest, the court may order the trustee to examine the acts and conduct of the debtor to determine whether a ground exists for denial of discharge.

(d) On request of the trustee, a creditor, or the United States trustee, and after notice and a hearing, the court shall revoke a discharge granted under subsection (a) of this section if—

(1) such discharge was obtained through the fraud of the debtor, and the requesting party did not know of such fraud until after the granting of such discharge;

(2) the debtor acquired property that is property of the estate, or became entitled to acquire property that would be property of the estate, and knowingly and fraudulently failed to report the acquisition of or entitlement to such property, or to deliver or surrender such property to the trustee; or

(3) the debtor committed an act specified in subsection (a) (6) of this section.

(e) The trustee, a creditor, or the United States trustee may request a revocation of a discharge—

(1) under subsection (d) (1) of this section within one year after such discharge is granted; or

(2) under subsection (d) (2) or (d) (3) of this section before the later of—

(A) one year after the granting of such discharge; and

(B) the date the case is closed.

11 U.S.C. § 727 (1988).

7. *See* 11 U.S.C. § 704 (1988) (enumerating the duties of a Chapter 7 trustee).

proceeding prevents a debtor from being discharged of *any* debt.[8]

2. *11 U.S.C. § 523—Nondischargeability Section*

Section 523 of the Bankruptcy Code, in contrast to § 727 which prevents *all* debt from being discharged, applies to creditor-specific debts such as a loan from a particular bank to the debtor. A successful "nondischargeability" action prevents a particular debt owed to the creditor commencing the action from being discharged.[9] However, it does not affect the discharge of

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8. *See* 11 U.S.C. § 727(a) and (c)(1) (1988).

9. *See* 11 U.S.C. § 523 (1988 & Supp. III 1991). Section 523 provides as follows:

(a) A discharge under section 727, 1141,[,] 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt—
  (1) for a tax or a customs duty—
    (A) of the kind and for the periods specified in section 507(a)(2) or 507(a)(7) of this title, whether or not a claim for such tax was filed or allowed;
    (B) with respect to which a return, if required—
      (i) was not filed; or
      (ii) was filed after the date on which such return was last due, under applicable law or under any extension, and after two years before the date of the filing of the petition; or
    (C) with respect to which the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat such tax;
  (2) for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by—
    (A) false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition;
    (B) use of a statement in writing—
      (i) that is materially false;
      (ii) respecting the debtor's or an insider's financial condition;
      (iii) on which the creditor to whom the debtor is liable for such money, property, services, or credit reasonably relied; and
      (iv) that the debtor caused to be made or published with intent to deceive; or
    (C) for purposes of subparagraph (A) of this paragraph, consumer debts owed to a single creditor and aggregating more than $500 for "luxury goods or services" incurred by an individual debtor on or within forty days before the order for relief under this title, or cash advances aggregating more than $1,000 that are extensions of consumer credit under an open end credit plan obtained by an individual debtor on or within twenty days before the order for relief under this title, are presumed to be nondischargeable; "luxury goods or services" do not include goods or services reasonably acquired for the support or maintenance of the debtor or a dependent of the debtor; an extension of consumer credit under an open end credit plan is to be defined for purposes of this subparagraph as it is defined in the Consumer Credit Protection Act (15 U.S.C. 1601 et seq.);
  (3) neither listed nor scheduled under section 521(1) of this title, with the name, if known to the debtor, of the creditor to whom such debt is owed, in time to permit—
    (A) if such debt is not of a kind specified in paragraph (2), (4), or (6) of this subsection, timely filing of a proof of claim, unless such creditor had notice or actual knowledge of the case in time for such timely filing; or
    (B) if such debt is of a kind specified in paragraph (2), (4), or (6) of this

subsection, timely filing of a proof of claim and timely request for a determination of dischargeability of such debt under one of such paragraphs, unless such creditor had notice or actual knowledge of the case in time for such timely filing and request;

(4) for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny;

(5) to a spouse, former spouse, or child of the debtor, for alimony to, maintenance for, or support of such spouse or child, in connection with a separation agreement, divorce decree or other order of a court of record, determination made in accordance with State or territorial law by a governmental unit, or property settlement agreement, but not to the extent that—

(A) such debt is assigned to another entity, voluntarily, by operation of law, or otherwise (other than debts assigned pursuant to section 402(a) (26) of the Social Security Act, or any such debt which has been assigned to the Federal Government or to a State or any political subdivision of such State); or

(B) such debt includes a liability designated as alimony, maintenance, or support, unless such liability is actually in the nature of alimony, maintenance, or support;

(6) for willful and malicious injury by the debtor to another entity or to the property of another entity;

(7) to the extent such debt is for a fine, penalty, or forfeiture payable to and for the benefit of a governmental unit, and is not compensation for actual pecuniary loss, other than a tax penalty—

(A) relating to a tax of a kind not specified in paragraph (1) of this subsection; or

(B) imposed with respect to a transaction or event that occurred before three years before the date of the filing of the petition;

(8) for an educational benefit overpayment or loan made, insured or guaranteed by a governmental unit, or made under any program funded in whole or in part by a governmental unit or a nonprofit institution, or for an obligation to repay funds received as an educational benefit, scholarship or stipend, unless—

(A) such loan, benefit, scholarship, or stipend overpayment first became due before 7 years (exclusive of any applicable suspension of the repayment period) before the date of the filing of the petition; or

(B) excepting such debt from discharge under this paragraph will impose an undue hardship on the debtor and the debtor's dependents;

(9) for death or personal injury caused by the debtor's operation of a motor vehicle if such operation was unlawful because the debtor was intoxicated from using alcohol, a drug, or another substance;

(10) that was or could have been listed or scheduled by the debtor in a prior case concerning the debtor under this title or under the Bankruptcy Act in which the debtor waived discharge, or was denied a discharge under section 727(a) (2), (3), (4), (5), (6), or (7) of this title, or under section 14c(1), (2), (3), (4), (6), or (7) of such Act;

(11) provided in any final judgment, unreviewable order, or consent order or decree entered in any court of the United States or of any State, issued by a Federal depository institutions regulatory agency, or contained in any settlement agreement entered into by the debtor, arising from any act of fraud or defalcation while acting in a fiduciary capacity committed with respect to any depository institution or insured credit union; or

(12) for malicious or reckless failure to fulfill any commitment by the debtor to a Federal depository institutions regulatory agency to maintain the capital of an insured depository institution, except that this paragraph shall not extend any such commitment which would otherwise be terminated due to any act of such agency.

(b) Notwithstanding subsection (a) of this section, a debt that was excepted from discharge under subsection (a)(1), (a)(3), or (a)(8) of this section, under

other debt.[10] Creditors often file a complaint asserting both § 523 and § 727 claims, believing that this will increase the likelihood of recovering some or all of the debt owed by the debtor to that creditor. However, a creditor with a sound nondischargeability claim should seriously consider not including § 727 claims in the § 523 complaint. The creditor's likelihood of recovering a debt that is nondischargeable under § 523 by levying upon a debtor's assets is greater when other debts have been discharged, because the creditor with the nondischargeability judgment is not competing with other creditors for the debtor's limited assets.

3. *11 U.S.C. § 522—Exemption Section*

Section 522 of the Bankruptcy Code, which does not directly apply to discharge or nondischargeability issues, is important because it is the operative section of the Bankruptcy Code which allows a debtor to exempt certain property from being included in a bankruptcy proceeding and permits the debtor to keep this property.[11] A principal focus of pre-bankruptcy planning is to

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section 17a(1), 17a(3), or 17a(5) of the Bankruptcy Act, under section 439A of the Higher Education Act of 1965 (20 U.S.C. 1087-3), or under section 733(g) of the Public Health Service Act (42 U.S.C. 294(f)) in a prior case concerning the debtor under this title, or under the Bankruptcy Act, is dischargeable in a case under this title unless, by the terms of subsection (a) of this section, such debt is not dischargeable in the case under this title.

(c) (1) Except as provided in subsection (a)(3)(B) of this section, the debtor shall be discharged from a debt of a kind specified in paragraph (2), (4), or (6) of subsection (a) of this section, unless, on request of the creditor to whom such debt is owed, and after notice and a hearing, the court determines such debt to be excepted from discharge under paragraph (2), (4), or (6), as the case may be, of subsection (a) of this section.

(2) Paragraph (1) shall not apply in the case of a Federal depository institutions regulatory agency seeking, in its capacity as conservator, receiver, or liquidating agent for an insured depository institution, to recover a debt described in subsection (a)(2), (a)(4), (a)(6), or (a)(11) owed to such institution by an institution-affiliated party unless the receiver, conservator, or liquidating agent was appointed in time to reasonably comply, or for a Federal depository institutions regulatory agency acting in its corporate capacity as a successor to such receiver, conservator, or liquidating agent to reasonably comply, with subsection (a)(3)(B) as a creditor of such institution-affiliated party with respect to such debt.

(d) If a creditor requests a determination of dischargeability of a consumer debt under subsection (a)(2) of this section, and such debt is discharged, the court shall grant judgment in favor of the debtor for the costs of, and a reasonable attorney's fee for, the proceeding if the court finds that the position of the creditor was not substantially justified, except that the court shall not award such costs and fees if special circumstances would make the award unjust.

(e) Any institution-affiliated party of a depository institution or insured credit union shall be considered to be acting in a fiduciary capacity with respect to the purposes of subsection (a)(4) or (11).

11 U.S.C. § 523 (1988 & Supp. III 1991).

10. *Id.*

11. *See* 11 U.S.C. § 522 (1988). Section 522 allows states to determine whether federal

maximize exemptions.[12] Unless objections to the exemptions are raised and sustained, the debtor is allowed to retain the exempt property, even if the debtor is denied a discharge.[13]

B. APPLICABILITY OF OBJECTIONS TO DISCHARGE (SECTION 727) AND NONDISCHARGEABILITY (SECTION 523) ACTIONS TO VARIOUS CHAPTERS OF THE BANKRUPTCY CODE

An objection to discharge under § 727 is only applicable in a Chapter 7 "liquidation" proceeding,[14] with the exception that it is applicable in Chapter 11 "reorganization" proceedings in limited circumstances.[15] It applies to a Chapter 11 reorganization when an individual's confirmed Chapter 11 plan of reorganization provides for liquidation of the assets, the individual does not engage in business thereafter, and the individual would be denied a discharge under § 727(a) if it were a Chapter 7 proceeding.[16]

It should be recognized that § 727 only applies to individuals.[17] Section 523, likewise applicable only to individuals, is fully applicable in individual Chapter 7, 11, 12 "farmer reorganization" proceedings, and certain Chapter 13 "wage earner reorganizations" where payments under a plan have not been completed.[18]

Only subsections 523(a)(5), (8) and (9) directly apply to all Chapter 13 proceedings.[19] Theoretically, a Chapter 13 plan may be confirmed despite the most egregious pre-bankruptcy conduct where other factors suggest that the plan represents a good faith attempt by the debtor to satisfy creditor claims.[20] However, factors which would support a nondischargeability or objection to discharge action are relevant to the good faith analysis.[21]

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exemptions enumerated at 11 U.S.C. § 522(d), state exemptions, or either at the debtor's option, may be utilized in a bankruptcy filing. 11 U.S.C. § 522(b) (1988).

12. *See* Panuska v. Johnson (*In re* Johnson), 80 B.R. 953, 957 (Bankr. D. Minn. 1987).

13. *See, e.g.*, Armstrong v. Lunday (*In re* Lunday), 100 B.R. 502, 507-09 (Bankr. D.N.D. 1989) (finding that an exemption claimed on a homestead was allowed but discharge was denied).

14. 11 U.S.C. § 103(b) (1988).

15. 11 U.S.C. § 1141(d)(3) (1988).

16. *Id.*

17. 11 U.S.C. § 727(a)(1) (1988).

18. 11 U.S.C. § 523(a) (1988 & Supp. III 1991); 11 U.S.C. § 1328(b) (1988).

19. 11 U.S.C. § 1328(a)(2) (1988 & Supp. III 1991).

20. Handeen v. LeMaire (*In re* LeMaire), 898 F.2d 1346, 1352 (8th Cir. 1990).

21. *See id.* at 1349 (finding of good faith by the bankruptcy court was clearly erroneous where the principal claimant had been intentionally shot five times by the debtor); Education Assistance Corp. v. Zellner (*In re* Zellner), 827 F.2d 1222, 1227 (8th Cir. 1987) (finding that a plan discharging a student loan obligation was proposed in good faith and also finding that the plan was a serious attempt to repay the student loan given debtor's projected income and health problems); United States v. Estus (*In re* Estus), 695 F.2d 311,

This article will principally focus on § 727 and actions which relate to it. The factual circumstances which give rise to a § 523 action generally occur prior to consulting with counsel when most obligations to creditors are incurred. Thus the facts are already established, and pre-bankruptcy planning will have little effect on a potential nondischargeability claim. However, conversion of collateral such as the debtor's failure to turn over to a creditor the proceeds from the unauthorized sale of a creditor's collateral, a basis for a nondischargeability claim under § 523(a)(6), periodically occurs prior to a bankruptcy filing. A nondischargeability claim will not succeed if collateral has been converted, unless it is established that the conversion was willful and malicious.[22]

> Debtors who willfully break security agreements are testing the outer bounds of their right to a fresh start, but unless they act with malice by intending or fully expecting to harm the economic interests of the creditor, such a breach of contract does not, in and of itself, preclude a discharge.[23]

C. DISTINCTION BETWEEN DENYING AN EXEMPTION AND DENYING A DISCHARGE

A claimed exemption in certain assets may be allowed even though a discharge is denied.[24] A comprehensive look at all transactions is included in a discharge analysis, whereas an exemption inquiry is far more limited.[25] Exemptions may be denied where fraudulent use of exemptions is determined to have occurred, after considering such indicia of fraud as, *inter alia*, (1) conduct intentionally designed to materially mislead or deceive creditors

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317 (8th Cir. 1982) (holding that a plan discharging a student loan obligation was not proposed in good faith).

22. 11 U.S.C. § 523(a)(6) (1988).

23. Barclays Am./Business Credit, Inc. v. Long (*In re* Long), 774 F.2d 875, 882 (8th Cir. 1985) (finding that malice was not established where debtor's principal intended to keep business going); *see* First Nat'l Bank v. Phillips (*In re* Phillips), 882 F.2d 302, 304-05 (8th Cir. 1989) (concluding that lease payments assigned to bank erroneously came into possession of corporate debtor who spent money; principals who had intended to keep business going filed bankruptcy and bank charges of embezzlement and willful and malicious injury were dismissed).

24. *See* Armstrong v. Lunday (*In re* Lunday), 100 B.R. 502 (Bankr. D.N.D. 1989). The debtors in *Lunday* disclosed a transfer of $58,000 into a homestead exemption, although they were not honest about the sources of the cash and they filed false schedules. *Id.* at 507-08. They were allowed to retain the homestead exemption but were denied the discharge because of their efforts to hide nonexempt assets from the trustee and creditors. *Id.* at 509.

25. Another distinction is that allowability of exemptions (where state exemptions are used) is governed by state law and discharge actions are governed by federal law. Norwest Bank of Neb. v. Tveten, 848 F.2d 871, 873 n.3, 876 (8th Cir. 1988).

about the debtor's financial position or (2) use of credit to buy exempt property.[26] However, the factors relevant to finding extrinsic fraud in a § 727(a) (denial of discharge) action apply to a determination as to whether an exemption should be allowed.[27] Courts particularly focus on whether acquiring the exemption furthers the following social policies:

1. To provide the debtor with property necessary for physical survival;
2. To protect the dignity and the cultural and religious identity of the debtor;
3. To enable the debtor to rehabilitate 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 the debtor's family with minimal financial support from society to the debtor's creditors.[28]

D. PROCEDURAL RULES

A § 727 or § 523 action is commenced by filing a complaint which commences an adversary proceeding governed by Bankruptcy Rules 7001 to 7087.[29] A nondischargeability or objection to discharge complaint shall be filed not later than sixty days following the first date set for the § 341 meeting of creditors.[30] In a Chapter 11 case, the complaint shall be filed not later than the first date set for the hearing on confirmation.[31] The court may extend the time for filing a complaint, on motion of a party in interest, provided that the motion is made before the allotted time has expired.[32]

Careful consideration as to whether the facts support and strategy dictates filing a nondischargeability or objection to discharge action should precede the commencement of such an

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26. Abbott Bank-Hemingford v. Armstrong (*In re* Armstrong), 931 F.2d 1233, 1237-39 (8th Cir. 1991).

27. *In re* Smith, 113 B.R. 579, 585 (Bankr. D.N.D. 1990); *see also* Hanson v. First Nat'l Bank (*In re* Hanson), 848 F.2d 866, 868 (8th Cir. 1988) (applying discharge factors in determining whether to sustain objection to exemption); *Armstrong*, 931 F.2d at 1239 (noting that factors establishing extrinsic fraud in discharge analysis are the same as in exemption objection analysis).

28. *See Smith*, 113 B.R. at 586.

29. *See* FED. R. BANKR. P. 7001-7087.

30. FED. R. BANKR. P. 4004(a).

31. *Id.*

32. FED. R. BANKR. P. 4004(b).

action. A motion to amend a § 727 complaint to add a § 523 count after the expiration of the statute of limitations period may not be granted because there is not "sufficient identity" between the claims.[33]

If a discharge was obtained "through the fraud of the debtor, and the requesting party did not know of such fraud until after the granting of such discharge," an action to revoke the discharge may be commenced within one year after the discharge was granted, even if there was no objection to discharge within the sixty-day requirement of Bankruptcy Rule 4004.[34] The right to commence a revocation action is a remedial right, however, which is difficult to obtain and should not be relied upon as an alternative to objecting to a discharge in a timely fashion.[35]

E. BURDEN OF PROOF

An objection to discharge seeks a remedy with serious consequences which courts do not grant lightly.[36] Facts relevant to such an objection are construed liberally in favor of the debtor and strictly against the objecting party.[37] The plaintiff generally has the initial burden of proving an objection to discharge.[38] On appeal, a finding by the bankruptcy court of whether fraud occurred is subject to the clearly erroneous standard.[39] Consequently, bankruptcy decisions in discharge objection cases are not often reversed on appeal.

The standard of proof in nondischargeability actions is the "preponderance of the evidence," which allows bankruptcy courts to "give collateral estoppel effect to those elements of the claim that are identical to the elements required for discharge and which were actually litigated and determined in the prior

33. *See* Austin Farm Ctr. v. Harrison (*In re* Harrison), 71 B.R. 457, 460 (Bankr. D. Minn. 1987). *But see* Bank of Chester County v. Cohen (*In re* Cohen), 139 B.R. 327, 335 (Bankr. E.D. Pa. 1992) (noting that *Harrison* failed to consider the "relating back" test arising from the more liberal amendment standards of Federal Rule of Civil Procedure 15(c) made applicable to adversary proceedings by Bankruptcy Rule 7015).

34. 11 U.S.C. § 727(d)(1), (e)(1) (1988).

35. *See* Mid-Tech Consulting, Inc. v. Swendra (*In re* Swendra), 938 F.2d 885, 888 (8th Cir. 1991) (holding that a dismissal of a revocation action under § 727(d)(1) was proper where the creditor knew of facts before discharge which put the creditor on notice of a possible fraud); Doe v. Zimmerman (*In re* Zimmerman), 869 F.2d 1126, 1128 (8th Cir. 1989) (finding that a creditor who did not file a timely objection to discharge was precluded from seeking a revocation of discharge).

36. Ashton v. Burke (*In re* Burke), 83 B.R. 716, 720 (Bankr. D.N.D. 1988).

37. *Id.*

38. FED. R. BANKR. P. 4005.

39. Jennen v. Hunter (*In re* Hunter), 771 F.2d 1126, 1129 n.3 (8th Cir. 1985).

action."[40] The standard of proof in an objection to discharge action is, however, unresolved. Although previously determined by many courts to be the clear and convincing standard,[41] most courts since *Grogan v. Garner*[42] have determined that the preponderance of the evidence standard applies in objection to discharge actions too.[43]

That intent which an objecting party must prove in order to sustain an objection to discharge is "actual intent." Actual intent is distinguishable from constructive intent in that constructive intent is inferred from facts as a matter of law without regard to the debtor's actual intent.[44] The courts nevertheless recognize that a debtor will seldom directly admit to having the intent necessary to deny a discharge. Consequently, courts will allow the requisite intent to be established by circumstantial evidence with inferences to be drawn from the actions of the debtor.[45]

The intent of one individual is generally not attributed to another when making a denial of discharge determination. Intent to defraud cannot be attributed from one spouse to the other spouse, but must be proven with respect to each.[46] In *Walker v. Citizens State Bank (In re Walker)*,[47] the court held that the fraud of the debtor's wife-agent, by itself, is not imputed to the debtor.[48] In this nondischargeability action based on fraud, the court held that actual participation in the fraud was not required and fraud would readily be imputed if an agent knew or should have known of the fraud.[49] The court added that if the principal was recklessly indifferent to the acts of the agent, it could be inferred that the principal should have known of the fraud.[50] Similarly, malice or intent of a conservator or guardian will not be imputed to an inca-

40. *See* Grogan v. Garner, 111 S. Ct. 654, 658 (1991) (finding that the preponderance of the evidence standard balances fresh start policy with interest of limiting opportunity for a new beginning to the "honest but unfortunate debtor").

41. *See, e.g., Grogan*, 111 S. Ct. at 658-59.

42. 111 S. Ct. 654 (1991). *See, e.g.*, St. Luke's Hosps. of Fargo, Inc. v. Smith (*In re* Smith), 119 B.R. 714, 721 (Bankr. D.N.D. 1990).

43. Grogan v. Garner, 111 S. Ct. 654, 661 (1991). *See* United States v. Sumpter (*In re* Sumpter), 136 B.R. 690, 693-94 (Bankr. E.D. Mich. 1991); Applebaum v. Henderson (*In re* Henderson), 134 B.R. 147, 150 (Bankr. E.D. Pa. 1991); Union Bank v. Farouki (*In re* Farouki), 133 B.R. 769, 776 (Bankr. E.D. Va. 1991).

44. *See* McDonough v. Erdman (*In re* Erdman), 96 B.R. 978, 985 (Bankr. D.N.D. 1988).

45. *Id.*

46. First Tex. Sav. Ass'n, Inc. v. Reed, 700 F.2d 986, 993 (5th Cir. 1983).

47. 726 F.2d 452 (8th Cir. 1984).

48. Walker v. Citizens State Bank (*In re* Walker), 726 F.2d 452, 454 (8th Cir. 1984).

49. *Id.*

50. *Id.* Although *Walker* involved a nondischargeability action, the standard for imputing an agent's intent to the principal would seem to be applicable to discharge actions. *But see* United States v. Sumpter (*In re* Sumpter), 136 B.R. 690, 696 (Bankr. E.D. Mich. 1991) (disagreeing with cases suggesting that reckless disregard is equivalent to

pacitated person on whose behalf the conservator or guardian was acting.[51]

Fraudulent intent is presumed in § 727(a)(2) cases where the debtor has gratuitously conveyed valuable property.[52] The burden then shifts to the debtor to prove that there was no intent to hinder, delay or defraud creditors.[53] On rebuttal, the debtor must prove that he or she did not commit the objectionable acts alleged.[54]

III. SECTION 727 IN PRACTICE

A. TRANSFER, REMOVAL, DESTRUCTION, MUTILATION OR CONCEALMENT OF PROPERTY (11 U.S.C. § 727(a)(2))

1. *Elements of an Objection to Discharge Under § 727(a)(2)*

A debtor will be denied a discharge under § 727(a)(2)(A) or (B) if the facts show that:

1. the debtor transferred, removed, destroyed, mutilated or concealed or permitted the same to be done,
2. to the debtor's property,
3. within one year preceding the case filing or during case pendency,
4. with the intent to hinder, delay, or defraud a creditor.[55]

2. *What Is a Transfer?*

The vast majority of cases addressing actions under § 727(a)(2), especially those with pre-bankruptcy exemption planning, focus on the "transfer" element of that section. Transfer is interpreted broadly and all inclusive. It means "every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property, including retention of title as a security interest and foreclosure of the debtor's equity of redemption."[56] The legislative history also con-

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fraudulent intent but concluding that reckless disregard as to the truth of a statement is tantamount to knowledge of its falsity for purposes of that element of § 727(a)(4)).

51. St. Luke's Hosps. of Fargo, Inc. v. Smith (*In re* Smith), 119 B.R. 714, 721 (Bankr. D.N.D. 1990) (finding that a purchase of annuities with $90,000 of settlement proceeds did not cause discharge of incapacitated person to be denied).

52. Abbott Bank-Hemingford v. Armstrong (*In re* Armstrong), 931 F.2d 1233, 1239 (8th Cir. 1991).

53. *Id.*

54. *See* Shainman v. Shear's of Affton, 387 F.2d 33, 37 (8th Cir. 1967).

55. McDonough v. Erdman (*In re* Erdman), 96 B.R. 978, 985 (Bankr. D.N.D. 1988).

56. 11 U.S.C. § 101(54) (1988).

firms that the definition of transfer is not a limiting term.[57]

The courts likewise interpret "transfer" broadly. In *City National Bank v. Bateman*,[58] the court held that the incorporation of a grocery store previously owned jointly by husband and wife, with the wife becoming a 100% shareholder, constituted a transfer which resulted in the denial of a discharge.[59] In *Conti-Commodity Services, Inc. v. Clausen*,[60] the court held that the loss of a homestead by default in a divorce proceeding was a transfer which occurred with the intent to defraud creditors.[61] Accordingly, the discharge was denied.[62]

Notwithstanding the broad interpretation of what constitutes a "transfer," there are limitations. A transfer of assets by a corporation in which the debtor owns fifty percent of the shares does not constitute a transfer of property of the debtor because the debtor did not have a direct proprietary interest in the property.[63] The Ninth Circuit in *First Beverly Bank v. Adeeb (In re Adeeb)*,[64] held that a transfer was not deemed to have occurred if the transfer was reversed prior to the bankruptcy petition filing or was in the process of being reversed at the time of an involuntary filing.[65] Counsel should not assume that *Adeeb* would be adopted in the Eighth Circuit, where the issue has not been ruled upon, given that the Eleventh Circuit has rejected the *Adeeb* analysis.[66] An

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57. Congress' intent in adopting an expansive view of "transfer" is clear.

> A transfer is a disposition of an interest in property. The definition of transfer is as broad as possible. Many of the potentially limiting words in current law are deleted, and the language is simplified. Under this definition, any transfer of an interest in property is a transfer, including a transfer of possession, custody, or control even if there is no transfer of title, because possession, custody, and control are interests in property. A deposit in a bank account or similar account is a transfer.

S. REP. NO. 989, 95th Cong., 2d Sess. 26-27 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5813; *see also* H.R. REP. NO. 595, 95th Cong., 2d Sess. 314 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6271.

58. 646 F.2d 1220 (8th Cir. 1981).

59. City Nat'l Bank v. Bateman (*In re* Bateman), 646 F.2d 1220, 1224-25 (8th Cir. 1981).

60. 44 B.R. 41 (Bankr. D. Minn. 1984).

61. Conti-Commodity Serv., Inc. v. Clausen (*In re* Clausen), 44 B.R. 41, 43-46 (Bankr. D. Minn. 1984).

62. *Id.* at 46.

63. MCorp. Management Solutions, Inc. v. Thurman (*In re* Thurman), 901 F.2d 839, 841 (10th Cir. 1990).

64. 787 F.2d 1339 (9th Cir. 1986).

65. First Beverly Bank v. Adeeb (*In re* Adeeb), 787 F.2d 1339, 1345 (9th Cir. 1986). Upon the advice of counsel, the debtor in *Adeeb* revised most of his original transfers prior to being forced into involuntary bankruptcy by his creditors. *Id.* at 1341-42.

66. Davis v. Davis (*In re* Davis), 911 F.2d 560, 562 (11th Cir. 1990). The court in *Davis* rejected *Adeeb* on the basis that the language of § 727(a)(2)(A) is plain and unambiguous and that "transferred" does not mean "transferred and remained transferred." *Id.* The court held that a transfer for § 727(a) purposes occurred and the debtor was denied a discharge even though the transfer was reversed pre-petition. *Id.*

ability to reverse transfers prior to filing and to preserve the discharge, as recognized in *Adeeb*, is a valuable remedial tool in courts where the *Adeeb* rationale is followed. It is a remedial cleansing mechanism for counsel involved in a case where inappropriate transfers previously occurred.

3. *"Extrinsic" Evidence of Fraud Supporting Denial of Discharge Under § 727(a)(2)*

Perfectly legitimate actions may "delay or hinder creditors . . . in the ordinary, nonlegal sense," but these acts are not the sort of hindrances covered by fraudulent transfer law or the Bankruptcy Code.[67] "[A] debtor's conversion of nonexempt property to exempt property on the eve of bankruptcy for the express purpose of placing that property beyond the reach of creditors, without more, will not deprive the debtor of the exemption to which he otherwise would be entitled."[68]

The Eighth Circuit in *Panuska v. Johnson* (*In re Johnson*)[69] recognized the following nonexclusive factors as constituting indicia of extrinsic evidence of fraud:

1. Further conduct intentionally designed to materially mislead or deceive creditors about the debtor's position;
2. Conveyances for less than fair value;
3. Continued retention, benefit or use of property allegedly conveyed together with evidence that the conveyance was for inadequate consideration; and
4. Where an exemption, other than a homestead, is not limited in amount, the amount of property converted into exempt forms and the form taken may be considered.[70]

Additional factors also constitute such evidence:

5. The debtor obtained credit to purchase exempt assets;
6. The conversion occurred after the entry of a large judgment against the debtor;

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67. *Armstrong*, 931 F.2d at 1238.

68. Hanson v. First Nat'l Bank (*In re* Hanson), 848 F.2d 866, 868 (8th Cir. 1988); *see* Wilder Health Care Ctr. v. Elholm (*In re* Elholm), 80 B.R. 964, 969 (Bankr. D. Minn. 1987) (stating that the meaning of hinder and delay is not a semantic exercise but must be determined in light of the purpose of § 727(a) and the Bankruptcy Code).

69. 880 F.2d 78 (8th Cir. 1989).

70. Panuska v. Johnson (*In re* Johnson), 880 F.2d 78, 82 (8th Cir. 1989).

7. The debtor had engaged in a pattern of sharp dealing prior to bankruptcy; and
8. That the conversion rendered the debtor insolvent.[71]

The North Dakota Bankruptcy Court has applied some of these factors along with certain others including:

9. The family, friendship or close associate relationship between the parties; and
10. The failure to schedule transfers of assets.[72]

4. *Application of Selected Extrinsic Fraud Factors*

a. Conduct Designed to Mislead or Deceive Creditors

Debtors must be very careful not to make misrepresentations when engaging in negotiations prior to bankruptcy. Whenever a debtor becomes involved in making misrepresentations to a creditor which has the effect of misleading the creditor, the discharge is put at risk. In *McCormick v. Security State Bank (In re McCormick)*,[73] an Iowa debtor was denied a discharge where he had engaged in the liquidation of assets to buy an exempt home and lied to his bank by stating that he was unable to make a payment when he had $55,000 to $60,000 in cash subject to his disposition at that time.[74] The debtor concealed the cash prior to acquiring his home by depositing funds in a credit union outside the state and by depositing additional funds in his wife's account.[75] The Eighth Circuit determined that the debtor intended to hinder or delay the creditor in collecting on the note and that the property was transferred in execution of that intent when funds were withdrawn from the accounts and transferred into the house.[76] The court concluded that concealment from the creditor constituted concealment under § 727 because the intent to hinder and delay collection was quite clear.[77] Although a finding of fraud requires more than a failure to volunteer information to creditors,[78] inten-

71. Smiley v. First Nat'l Bank (*In re* Smiley), 864 F.2d 562, 567 (7th Cir. 1989).
72. *See* McDonough v. Erdman (*In re* Erdman), 96 B.R. 978, 985 (Bankr. D.N.D. 1988). The court denied the debtor's discharge due to the debtor's egregious conduct, which included the wholesale transfers of assets, nondisclosure and failure to explain asset deficiency. *Id.* at 989.
73. 822 F.2d 806 (8th Cir. 1987).
74. McCormick v. Security State Bank (*In re* McCormick), 822 F.2d 806, 807-08 (8th Cir. 1987).
75. *Id.* at 807.
76. *Id.* at 808.
77. *Id.*
78. Smiley v. First Nat'l Bank (*In re* Smiley), 864 F.2d 562, 567 (7th Cir. 1989).

tional deception designed with the hope that creditors will refrain from pursuing remedies is a basis for denying discharge.[79]

b. Continued Retention and Use of Property

The plain language of § 727(a)(2) suggests that as long as transfers occur more than a year prior to bankruptcy filing, the discharge will not be jeopardized. However, the "continued concealment doctrine" is used by courts in concluding that certain transactions which facially occurred more than a year prior to bankruptcy constitute transfer or concealment within the year prior to bankruptcy.[80] Concealing property under § 727(a)(2)(A) occurs by a transfer of title coupled with retention of the benefits of ownership.[81] Even if a transfer occurs several years prior to bankruptcy, the continued concealment doctrine provides that the concealment, with the requisite intent, into the year prior to bankruptcy, puts the transaction within the one year requirement of § 727(a)(2)(A).[82]

As with most objections to discharge, application of the continued concealment doctrine is very fact specific. In *Bennett & Kahnweiler Associates v. Ratner (In re Ratner)*,[83] the debtor transferred his interest in a home to his spouse several years prior to bankruptcy, arguably when still solvent.[84] The debtor had deposited his salary into his wife's bank account to be used for household purposes, after his account was involuntarily closed.[85] The court held that the debtor did not intend to hinder, delay or defraud creditors and was not denied a discharge.[86] However, in another instance a small prepayment of future obligations was held to be

79. *See* First Tex. Sav. Ass'n, Inc. v. Reed (*In re* Reed), 700 F.2d 986, 991 (5th Cir. 1983) (finding that conversion of nonexempt assets to reduce home mortgage after arranging with creditors to be free of payment obligations until following year evidenced fraudulent intent); *Smiley*, 864 F.2d at 568 (denying a discharge because the debtor misrepresented asset values and transactions at several creditor meetings before bankruptcy and caused creditors to stand still long enough to allow debtor to establish residency in another state to take advantage of homestead exemption there).

80. Penner v. Penner (*In re* Penner), 107 B.R. 171, 175 (Bankr. N.D. Ind. 1989).

81. Thibodeaux v. Olivier (*In re* Olivier), 819 F.2d 550, 553 (5th Cir. 1987).

82. *Id.* at 555.

83. 132 B.R. 728 (N.D. Ill. 1991).

84. Bennett & Kahnweiler Assocs. v. Ratner (*In re* Ratner), 132 B.R. 728, 732-33 (N.D. Ill. 1991).

85. *Id.*

86. *Id.* (concluding that debtor had no obligation to open an account in his name or to share an account with his wife and that debtor had no obligation to retain attachable property for the benefit of his judgment creditors). *But see* Friedell v. Kauffman (*In re* Kauffman), 675 F.2d 127, 128 (7th Cir. 1981) (concluding that debtor who transferred home to his wife but retained all beneficial interest, including scheduling on financial statement and using as collateral for loans, was denied a discharge).

sufficient to deny discharge.[87]

c. Amount of Transfer and Form of Property

Much of the judicial discretion in reviewing transfers of nonexempt into exempt property has traditionally focused on the value of the transfer and the form of property into which the funds ultimately were transferred.

A classic example of a large transfer is discussed in *Norwest Bank Nebraska, N.A. v. Tveten (In re Tveten)*,[88] in which the Eighth Circuit affirmed the bankruptcy court's denial of a discharge after the debtor liquidated his nonexempt assets and converted over $700,000 into certain nonhomestead assets which the debtor thought were exempt.[89] The Eighth Circuit noted that the debtor's actions evidenced a desire for a "head start" and not a "fresh start"[90] and opined that "where a pig becomes a hog it is slaughtered."[91] The *Tveten* court suggested that the state exemption relied upon was unlimited and therefore provided the potential for unlimited abuse. The court in *Tveten* found that the debtor's conduct went well beyond the social policies underlying exemptions; however, the court did not provide any clear guidelines as to when liberal exemptions are deemed to be unlimited.[92]

The Eighth Circuit in *Hanson v. First National Bank (In re Hanson)*,[93] decided the same day as *Tveten*, applied the *Tveten* discharge analysis to an exemption objection with facts similar to *Tveten*, and allowed an exemption with transfers similar to *Tveten*.[94] However, in *Hanson* only $35,000 was transferred into exempt assets, including life insurance policies and pay down of a homestead mortgage, which indicates that the amount being

87. Albuquerque Nat'l Bank v. Zouhar (*In re* Zouhar), 10 B.R. 154, 158 (Bankr. D.N.M. 1981) (finding that prepayment of $1,860 of son's school tuition three months before due was a transfer with intent to defraud creditors in a case under the Bankruptcy Act).

88. 848 F.2d 871 (8th Cir. 1988).

89. Norwest Bank Neb., N.A. v. Tveten (*In re* Tveten) 848 F.2d 871, 872-73 (8th Cir. 1988); *see* McDonough v. Erdman (*In re* Erdman), 96 B.R. 978 (Bankr. D.N.D. 1988). The discharge was denied because there were wholesale gratuitous transfers of assets, and conversion of nonexempt assets to exempt assets exceeded social policies underlying exemption. *Id.* at 986.

90. *Tveten*, 848 F.2d at 876.

91. *Id.* at 879 (quoting Albuquerque Nat'l Bank v. Zouhar (*In re* Zouhar), 10 B.R. 154, 157 (Bankr. D.N.M. 1981)). *See also* NCNB Tex. Nat'l Bank v. Bowyer, 916 F.2d 1056, 1056 (5th Cir. 1990), *rev'd on reh'g*, 932 F.2d 1100 (5th Cir. 1991) (finding that the bankruptcy court's holding that spending spree including use of cash and not bank deposits for travel, home improvements and other exempt assets was not clearly erroneous and the discharge was allowed).

92. *Tveten*, 848 F.2d at 876.

93. 848 F.2d 866 (8th Cir. 1988).

94. Hanson v. First Nat'l Bank (*In re* Hanson), 848 F.2d 866, 869 (8th Cir. 1988).

transferred is an important factor.[95] Another distinction was that state law limited insurance exemptions to $20,000 in *Hanson* whereas *Tveten* had an unlimited exemption.[96] Finally, the debtor in *Tveten* was a practicing physician and the debtors in *Hanson* were farmers.[97] In both cases, the Eighth Circuit affirmed the lower court's finding relative to the presence and absence of fraudulent intent because that finding was not clearly erroneous.[98]

In the Eighth Circuit, the safest method of transferring cash or proceeds from nonexempt assets is by the acceleration of payments on a homestead mortgage.[99] The Eighth Circuit in *Panuska v. Johnson* unequivocally stated that the power sanctioned in *Tveten* to look at the money involved should be reserved for exceptional cases and had no application to homestead exemptions because such exemptions are central to state exemption laws.[100] Under *Panuska v. Johnson*, the pay down of $175,000 on a mortgage on an exempt homestead did not jeopardize a discharge.[101]

A question unanswered by *Panuska v. Johnson* is whether a debtor with liquid nonexempt assets which exceed the homestead mortgage balance may sell the homestead and buy a larger home as a means of preserving the nonexempt assets. The Eighth Circuit has not precluded the acquisition of a more expensive home prior to a bankruptcy filing, although it could be argued that such an action goes beyond the social policy of the homestead exemption, which under the Minnesota exemption construed in *Panuska v. Johnson* is to protect a homestead of the debtor and not necessarily to allow the debtor to buy a more expensive home.[102]

A Minnesota bankruptcy court in *In re Johnson*,[103] citing the Eighth Circuit *Panuska v. Johnson* decision, did not find extrinsic evidence of fraud and therefore allowed an exemption by a debtor who had not owned a home but who purchased a home for $45,000 a few hours before filing bankruptcy.[104] Similarly, in *Park National Bank v. Whitney (In re Whitney)*,[105] the debtor obtained

95. *Id.* at 867.
96. *Id.* at 867; *Tveten*, 848 F.2d at 873.
97. *Hanson*, 848 F.2d at 867; *Tveten*, 848 F.2d at 872.
98. *Hanson*, 848 F.2d at 869; *Tveten*, 848 F.2d at 876-77.
99. Panuska v. Johnson (*In re* Johnson), 880 F.2d 78, 83-84 (8th Cir. 1989).
100. *Id.*
101. *Id.* at 79, 83-84.
102. *See* Denzen v. Prendergast, 126 N.W.2d 440, 443 (Minn. 1964).
103. No. 6-88-594, 1989 WL 81184 (Bankr. D. Minn. July 21, 1989).
104. *In re* Johnson, No. 6-88-594, 1989 WL 81184, at *3 (Bankr. D. Minn. July 21, 1989).
105. 107 B.R. 645 (Bankr. D. Minn. 1989).

$400,335 in excess proceeds from a letter of credit draw.[106] The proceeds from the letter of credit were kept in the debtor's attorney's trust account in part to keep the funds away from creditors.[107] The funds were ultimately used to pay for a $280,000 home three months prior to filing bankruptcy, at a time when the debtor did not own another home.[108] Although this case dealt with objections to the homestead exemption, and not an objection to discharge, the extrinsic evidence of fraud factors applicable to an objection to discharge were applied.[109] Finding no fraud, the court overruled objections to the claimed exemption.[110]

The ultimate irony in the Eighth Circuit *Panuska v. Johnson* decision is that the case was remanded to determine whether the debtor acted with an intent to "hinder, delay, and defraud creditors" when he liquidated assets to acquire a life insurance policy with a $4,000 cash value, a baby grand piano, and an $8,000 harpsichord, all of which were exempt under state law.[111] The debtor was denied a discharge because of these transfers.[112] Extrinsic evidence of fraud was established because the insurance policy was acquired with the intent to be liquidated after bankruptcy to provide ready cash, which it subsequently was, and because the debtor did not know how to play the musical instruments nor did anyone in the family domicile.[113] The bankruptcy court on remand found that the debtor did not acquire any of these assets for the purpose which the legislature sought to advance in allowing them to be declared exempt.[114]

d. Family Relationship Between Parties

Family transfers are generally suspect. A presumption of fraud arises when property is transferred to relatives, in conjunction with other circumstances.[115] Courts have found that a sale of assets to family members for fair consideration, without more,

106. Park Nat'l Bank v. Whitney (*In re* Whitney), 107 B.R. 645, 648 (Bankr. D. Minn. 1989).

107. *Id.*

108. *Id.*

109. *Id.* at 650, 653.

110. *Id.* at 654.

111. *See* Panuska v. Johnson (*In re* Johnson), 124 B.R. 290, 292 (Bankr. D. Minn. 1991).

112. *Id.* at 297.

113. *Id.*

114. *Id.*

115. Pavy v. Chastant (*In re* Chastant), 873 F.2d 89, 91 (5th Cir. 1989) (finding that gratuitous transfer of property into family trust evidenced fraudulent intent and discharge was denied).

does not constitute fraud.[116] However, the perils of transferring assets to family members, even for apparent fair value, are illustrated in *Wilder Health Care Center v. Elholm (In re Elholm)*.[117] In *Elholm*, the debtor sold property to his wife and children, presumably paid for with the wife's and children's funds, which the court found the debtor and his wife had generated during the course of their marriage, for mutually beneficial family uses.[118] The court concluded that the funds in the wife's bank account were property of their marital community and not the wife's alone.[119] The court determined that the debtor did not intend to defraud, but had the requisite intent to hinder and delay; consequently, the discharge was denied.[120]

Transactions between family members will be even more suspect when the transaction is unusual on its face. The Fourth Circuit has held that a husband who transferred an interest in real estate to himself and his wife as tenants by the entirety with the right of survivorship one day after a judgment was entered against him to allegedly correct a six-month old mistake in a prior deed, acted with the intent to defraud.[121] Consequently, the court held that he was not entitled to a discharge.[122] However, the Seventh Circuit has held that fraud was not established by a "relinquishment" of a tenancy by the entirety interest from one spouse to another to allocate property in contemplation of divorce, even though the couple did not divorce, because the assets available to the creditors were not diminished by the transfer.[123]

A debtor should be as cautious about disposing of property of a marital estate, in violation of or to circumvent a divorce decree, as the debtor should generally be when disposing of property held for another. Several courts have denied a discharge of the converting spouse's debts, when the spouse converted the property or funds prior to or after a bankruptcy filing.[124]

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116. *See* Hanson v. First Nat'l Bank (*In re* Hanson), 848 F.2d 866, 869 (8th Cir. 1988) (finding that proceeds from sale were used to pay down mortgage on home).

117. 80 B.R. 964 (Bankr. D. Minn. 1987).

118. Wilder Health Care Ctr. v. Elholm (*In re* Elholm), 80 B.R. 964, 970-71 (Bankr. D. Minn. 1987).

119. *Id.*

120. *Id.*

121. Ford v. Poston (*In re* Ford), 773 F.2d 52, 53, 55 (4th Cir. 1985).

122. *Id.* at 55.

123. Lee Supply Corp. v. Agnew (*In re* Agnew), 818 F.2d 1284, 1285-86 (7th Cir. 1987).

124. *See* Gepfrich v. Gepfrich (*In re* Gepfrich), 118 B.R. 135, 138-39 (Bankr. S.D. Fla. 1990) (finding extrinsic evidence of fraud and denying discharge of debtor who filed bankruptcy after converting proceeds of marital asset into exempt annuity over which divorce decree had given debtor control to allow flexibility in making alimony and child support payments); Lanker v. Wheeler (*In re* Wheeler), 101 B.R. 39, 48-50 (Bankr. N.D. Ind.

B. DISCHARGE DENIED WHERE DEBTOR MAINTAINS POOR RECORDS OR NO RECORDS—11 U.S.C. § 727(a)(3)

Section 727(a)(3) provides that a debtor will be denied a discharge if the debtor "concealed, destroyed, mutilated, falsified, or failed to keep or preserve any recorded information . . . from which the debtor's financial condition or business transactions might be ascertained . . . unless . . . justified."[125] This section is meant to assure that the estate will be provided with sufficient information to assess the debtor's estate and financial posture. It will be applied on a case-by-case basis according to the special characteristics of the debtor's occupation, business and personal financial structure.[126]

There is no absolute obligation to keep books and records.[127] A party challenging the adequacy of a debtor's records has the initial burden of proving that the records are inadequate.[128] The burden then shifts to the debtor to justify the absence of complete records.[129] The test adopted by the Third Circuit is whether " 'there [is] available written evidence made and preserved from which the present financial condition of the bankrupt, and his business transactions for a reasonable period in the past may be ascertained.' "[130] Factors considered in determining whether the debtor's records are adequate include: the debtor's education, business experience and sophistication, the volume and complexity of the debtor's business or finances, the amount of credit extended to the debtor and any other relevant circumstances.[131] Although formal records are not required of every debtor, the financial history of complex business transactions for those required to keep records requires a paper trail more detailed than boxes of cancelled checks and documents.[132]

1989) (holding that the debtor was denied a discharge where the bankruptcy was a conscious scheme of the debtor undertaken to frustrate a divorce decree).

125. 11 U.S.C. § 727(a)(3) (1988).

126. Peoples State Bank v. Drenckhahn (*In re* Drenckhahn), 77 B.R. 697, 707 (Bankr. D. Minn. 1987).

127. Jaffe v. Nguyen (*In re* Nguyen), 100 B.R. 581, 583 (Bankr. M.D. Fla. 1989) (determining that it was conceivable, based on debtor's simplistic financial affairs, that debtor did not keep books and records, thus a discharge objection was not sustained).

128. American Motors Leasing Corp. v. Morando (*In re* Morando), 116 B.R. 14, 15 (Bankr. D. Mass. 1990).

129. *Id.*

130. Meridian Bank v. Alten (*In re* Alten), 958 F.2d 1226, 1230 (3d Cir. 1992) (citations omitted).

131. *Id.* at 1231. The court found that the debtors who elected to operate with cash, and without bank accounts, after creditors began levying were not justified in failing to maintain adequate records and therefore the discharge was denied. *Id.* at 1234.

132. *See Morando*, 116 B.R. at 16-17 (holding that a lack of formal education did not justify inadequate records for a debtor who was "no small Mom and Pop operator").

Courts will, however, consider reasonable explanations in determining whether the failure to keep adequate records is justified. In *Cox v. Lansdowne* (*In re Cox*),[133] which involved a massive securities fraud scheme, the court held that when a married couple share a duty to maintain records under § 727(a)(3), the "court should not refuse to consider one spouse's reliance on the other in determining whether a failure to keep records was justified under all the circumstances of the case."[134]

C. DISCHARGE DENIED WHEN DEBTOR KNOWINGLY MAKES A FALSE OATH OR FALSE CLAIM, COMMITS BRIBERY OR WITHHOLDS RECORDED INFORMATION FROM AN OFFICER OF THE ESTATE—11 U.S.C. § 727(a)(4)

One of the requirements of the Bankruptcy Code is that a debtor complete and file a series of schedules and forms containing questions relating to the debtor's assets, liabilities and financial affairs.[135] The discharge may be denied if the debtor fails to comply with this obligation.[136] Many times a debtor files schedules in haste and errors inadvertently occur. Nevertheless, false schedules may be considered a reckless indifference to the truth and the equivalent of fraud unless the debtor promptly amends the schedules to correct the errors.[137] Errors or omissions on these forms, which are signed under oath, can result in a denial of a discharge if the false oath was knowingly and fraudulently made and was "material."[138] The subject matter of a false oath is material if it bears a relationship to the debtor's business transactions or estate, or if it concerns the discovery of assets, business dealings, or the existence and disposition of the debtor's property.[139]

The fact that items omitted are of no value is not necessarily a defense to nondisclosure.[140] The purpose of disclosure is to allow creditors the opportunity to review and investigate assets and transactions. A debtor has no discretion in deciding which ques-

133. 904 F.2d 1399 (9th Cir. 1990).
134. Cox v. Lansdowne (*In re* Cox), 904 F.2d 1399, 1403 (9th Cir. 1990).
135. 11 U.S.C. § 521 (1988).
136. *See* 11 U.S.C. § 727(a)(4) (1988).
137. Drewes v. Magnuson (*In re* Magnuson), 113 B.R. 555, 559 (Bankr. D.N.D. 1989).
138. Ashton v. Burke (*In re* Burke), 83 B.R. 716, 720 (Bankr. D.N.D. 1988).
139. Palatine Nat'l Bank v. Olson (*In re* Olson), 916 F.2d 481, 484 (8th Cir. 1990).
140. Job v. Calder (*In re* Calder), 907 F.2d 953, 955 (10th Cir. 1990) (finding that an omission of two bank accounts, ownership interest in mineral rights and partnership interest (although presumably of no value), was basis for denying discharge to bankruptcy lawyer).

tions on the bankruptcy schedules to answer or which assets to disclose.[141] However, it is recognized that legitimate errors in the disclosure process occur.[142]

The Eighth Circuit has been unforgiving in nondisclosure cases, even where the value of assets at issue are relatively nominal. In *Mertz v. Rott* (*In re Rott*),[143] the Eighth Circuit affirmed the bankruptcy court which held that the nondisclosure of a $1,358 tax refund, which represented 5.8% of the assets and 1.5% of total liabilities, was material and was a valid basis to deny discharge even where the property, had it been disclosed, would have been exempt and would not have been available for distribution to creditors.[144] In *Rott*, the debtor had given three false oaths and had failed to correct the nondisclosure on three separate occasions.[145]

In *Palatine National Bank v. Olson* (*In re Olson*),[146] the Eighth Circuit Court of Appeals upheld the denial of a discharge to a debtor businessman who had sold his stock in a corporation to his wife six years before the debtor's bankruptcy filing.[147] His wife eventually became president of the corporation and general manager of the dinner theater operated by the corporation.[148] The debtor omitted any reference to the corporation or to the dinner theater on his bankruptcy schedules.[149] The Eighth Circuit upheld the bankruptcy court's finding of intentional nondisclosure evidenced by: (1) the debtor investing significant money in the theater after the sale of his stock, (2) the debtor having arranged all financing, and (3) the debtor's wife having had no experience in the development of such projects.[150] The bankruptcy court found

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141. *Burke*, 83 B.R. at 721. The court held that the exclusion of a professional practice on asset schedules of a dentist was due to confusion and not an intent to omit relevant data, and dismissed a complaint objecting to the discharge. The court found that the personal services of a dentist in a dental practice do not constitute estate property and are too speculative to value, but that patient records and files may have value and should be disclosed. *Id.* at 721-22.

142. *See, e.g.*, Continental Ill. Nat'l Bank and Trust Co. v. Bernard (*In re* Bernard), 99 B.R. 563, 570 (Bankr. S.D.N.Y. 1989). The court opined that:

> [a] debtor's omission of items without intent to conceal them from creditors, due either to inadvertence or because the property is not the type that comes to mind when listing one's disposable property, would not constitute a knowingly false statement under oath made by a debtor with intent to defraud creditors.

Id.

143. 955 F.2d 596 (8th Cir. 1992).
144. Mertz v. Rott (*In re* Rott), 955 F.2d 596, 598 (8th Cir. 1992).
145. *Id.* at 598-99.
146. 916 F.2d 481 (8th Cir. 1990).
147. Palatine Nat'l Bank v. Olson (*In re* Olson), 916 F.2d 481, 483-84 (8th Cir. 1990).
148. *Id.* at 483.
149. *Id.*
150. *Id.*

that the debtor "controlled the project in concept, development, and operation."[151] The bankruptcy court noted that the theater was of questionable value.[152] Nevertheless, the Eighth Circuit, concluding that value was not determinative, held that the omission was material because it related in a substantial way to the debtor's business transactions and his estate.[153]

The North Dakota Bankruptcy Court has been equally unsympathetic with debtors who are not truthful. In *Drewes v. Magnuson (In re Magnuson)*,[154] the debtors reported cash on original schedules in the amount of $218 when they actually had $1,168 which included $400 in a drawer set aside for their son's tuition.[155] The debtors' discharges were revoked and they were not allowed to exempt the cash included on amended schedules because the debtors fraudulently failed to disclose the cash and did not immediately amend their schedules when they allegedly became aware of the error.[156]

Courts seem to focus on whether assets are disclosed and not on whether the assets may have been undervalued, presumably believing that if the assets are disclosed, the trustee or creditors can ascertain the value. Although assets should never be undervalued intentionally, undervalued assets which are otherwise properly listed in a debtor's schedules have been held to be an insufficient basis to deny discharge.[157]

D. FAILURE TO EXPLAIN LOSS OF ASSETS—11 U.S.C. § 727(a)(5)

Many creditors and some trustees routinely suspect that a debtor has secreted assets. A debtor must be prepared to adequately account for assets which existed prior to the bankruptcy filing. A debtor may be denied a discharge if he or she is unable to do so.[158] Although it is the party objecting to a discharge who bears the burden of persuasion, this evidentiary rule does not eliminate a debtor's obligation to provide a satisfactory explanation for

151. Palatine Nat'l Bank v. Olson (*In re* Olson), 98 B.R. 944, 953 n.14 (Bankr. D. Minn. 1988).

152. *Id.* at 953.

153. *Olson*, 916 F.2d at 484.

154. 113 B.R. 555 (Bankr. D.N.D. 1989).

155. Drewes v. Magnuson (*In re* Magnuson), 113 B.R. 555, 558-59 (Bankr. D.N.D. 1989).

156. *Id.* at 558-60.

157. *See* Wines v. Wines (*In re* Wines), 114 B.R. 794, 797 (Bankr. S.D. Fla. 1990).

158. *See* 11 U.S.C. § 727(a)(5) (1988).

missing assets.[159] "Vague and indefinite explanations of losses that are based upon estimates uncorroborated by documentation are unsatisfactory."[160]

Objections to discharge premised upon a failure to account for assets are often pursued in conjunction with an objection based on a failure to keep adequate records.[161] These types of claims routinely arise in instances where individuals dispose of significant assets prior to bankruptcy, often for cash, and are unable to account for the asset disposition or proceeds.[162]

In one instance, debtors were denied a discharge because they were unable to provide documentation to account for the use of approximately $18,000 of $54,000 at their disposal during fourteen months prior to bankruptcy, which the debtors stated was used for cash purchases.[163] A debtor's explanation that the loss of assets is due to unsubstantiated gambling losses is unsatisfactory.[164] A debtor must be prepared to provide corroborating papers and documentation to support an explanation of asset deficiency when the debtor's testimony does not bear sufficient credibility.[165]

E. REFUSAL TO OBEY ORDER OF COURT OTHER THAN ORDER TO TESTIFY—11 U.S.C. § 727(a)(6)

A debtor who elects to seek the relief afforded by bankruptcy must play by the bankruptcy rules.[166] A debtor will not be granted a discharge if the debtor fails to obey a lawful order of the

159. Reed v. First Tex. Sav. Ass'n (*In re* Reed), 700 F.2d 986, 992-93 (5th Cir. 1983).

160. Meridian Bank v. Alten, 958 F.2d 1226, 1233 (3d Cir. 1992).

161. *See, e.g.*, Chalik v. Moorefield (*In re* Chalik), 748 F.2d 616, 620 (11th Cir. 1984).

162. *See* Grant v. Simmons (*In re* Simmons), 113 B.R. 741, 742-45 (Bankr. M.D. Fla. 1990) (finding that a debtor who had closed depository accounts after being sued by creditors was denied discharge because of an inability to account for a decline in assets from $6,000,000 to $80,932 during a two-year period prior to the bankruptcy); Manhattan Leasing Sys., Inc. v. Goblick (*In re* Goblick), 93 B.R. 771, 775-76 (Bankr. M.D. Fla. 1988).

In *Goblick* the debtor husband, whose net worth declined from in excess of $8,000,000 eight months prior to bankruptcy to a negative $3,000,000 before the bankruptcy filing, was denied a discharge for failure to maintain extensive records and for failure to explain disposition of assets. *Id.* at 775-76. The husband's co-debtor housewife, with no independent income, was nevertheless justified in not maintaining records, and was granted a discharge, although the explanation of the loss of a diamond ring was questionable. *Id.*

163. Jessell v. Sword (*In re* Sword), 93 B.R. 757, 760 (Bankr. M.D. Fla. 1988). *See Reed*, 700 F.2d at 989 (finding that an explanation that unaccounted disposition of $19,586 of cash was used for cash purchases without receipts was insufficient).

164. *See* Dignam v. McMahon (*In re* McMahon), 116 B.R. 857, 861 (Bankr. M.D. Fla. 1990) (concluding that a debtor's explanation that $25,500 was lost gambling was not sufficient account of diminution of assets).

165. *See* Peoples State Bank v. Drenckhahn (*In re* Drenckhahn), 77 B.R. 697, 710 (Bankr. D. Minn. 1987); McDonough v. Erdman (*In re* Erdman), 96 B.R. 978, 988 (Bankr. D.N.D. 1988).

166. *See* 11 U.S.C. § 521 (1988).

court or to testify to questions approved by the court.[167] However, absent a grant of immunity from prosecution in a later criminal proceeding, a debtor may properly assert the Fifth Amendment right against compelled self-incrimination, in court or at a § 341 meeting, while still retaining the right to be discharged.[168] Most courts will not allow a blanket assertion of the privilege, but generally require that the question of whether there is a reasonable basis for asserting the Fifth Amendment protection be asserted on a question-by-question basis.[169]

F. OTHER FACTORS APPLICABLE TO A § 727 DETERMINATION

1. *Reliance on Attorney Advice*

Reliance on an attorney's advice only protects a debtor to the extent that the reliance was (1) reasonable, (2) the advice was well informed, and (3) the advice was given by the attorney after being provided with all relevant facts.[170] This "rule" provides limited protection, because it seems that when bankruptcy planning violates § 727(a), courts will often find that reliance is unreasonable.[171]

2. *Whether Estate Is Harmed by Transfer*

Even if property transferred is exempt or if no equity remains, some courts, including the Eighth Circuit, hold that injury to creditors is not, as a matter of law, a requirement for the denial of a discharge.[172]

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167. 11 U.S.C. § 727(a)(6) (1988).

168. *See* Martin-Trigona v. Belford (*In re* Martin-Trogona), 732 F.2d 170, 173 (2d Cir. 1984), *cert. denied*, 469 U.S. 859 (1984).

169. *See In re* French, 127 B.R. 434, 439 (Bankr. D. Minn. 1991).

170. *Erdman*, 96 B.R. at 985. *See* City Nat'l Bank v. Bateman (*In re* Bateman), 646 F.2d 1220, 1224 (8th Cir. 1981); Barnett Bank of Tampa, N.A. v. Muscatell (*In re* Muscatell), 113 B.R. 72, 75 (Bankr. M.D. Fla. 1990) (finding that a sophisticated businessman's alleged reliance on counsel's advice that it was not necessary to list jointly held accounts on schedules was unreasonable).

171. *See, e.g.*, Norwest Bank Neb., N.A. v. Tveten, 848 F.2d 871, 876 (8th Cir. 1988) (finding that reliance on counsel's advice in liquidating nonexempt assets and transferring proceeds of approximately $700,000 into life insurance and annuity contracts was not reasonable); *Bateman*, 646 F.2d at 1224 (holding that excluding income and a gift from bankruptcy petition on the advice of counsel was unreasonable).

172. *See* Mertz v. Rott (*In re* Rott), 955 F.2d 596, 598 (8th Cir. 1992); First Beverly Bank v. Adeeb (*In re* Adeeb), 787 F.2d 1339, 1343 (9th Cir. 1986); Future Time, Inc. v. Yates, 26 B.R. 1006, 1008-09 (M.D. Ga.), *aff'd*, 712 F.2d 1417 (11th Cir. 1983). *But see* Shields v. Miera (*In re* Miera), 104 B.R. 989, 993 (Bankr. D. Minn. 1989); People's State Bank v. Drenckhahn (*In re* Drenckhahn), 77 B.R. 697, 705 (Bankr. D. Minn. 1987).

IV. PRACTICAL SUGGESTIONS

A. SUMMARY OF DEBTOR-COUNSEL'S ROLE IN PLANNING FOR BANKRUPTCY

1. Provide clients with a detailed retention letter, advising them of the bankruptcy process and issues, and warning them that *any* transfer prior to bankruptcy has some level of risk associated with it. Require that the letter be signed and returned with an acknowledgement that the materials have been read and understood and that any terms contained therein have been agreed upon.

2. Advise clients of the applicable law and risks. Insist that the client make the ultimate decision as to the extent of "planning" in which to engage.

3. Be aware, and apprise clients, of criminal statutes so that clients do not unknowingly commit a crime. Intentional false representations made to obtain credit from financial institutions are criminal acts.[173] Intentional concealment, removal or transfer of property in which another has a security interest, without the prior consent of the secured party, is also a criminal act.[174] A party to a conveyance or assignment entered into with the intent to defraud has also committed a criminal act.[175] Knowingly and

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173. *See* 18 U.S.C. § 1014 (1988 & Supp. III 1991).

174. N.D. CENT. CODE § 12.1-23-08 (1985). Section 12.1-23-08 provides as follows:

Defrauding Secured Creditors.

1. An owner of property who creates a security interest in such property may not intentionally alter, conceal, destroy, damage, encumber, transfer, remove, or otherwise deal with property that is subject to the security interest without the prior consent of the secured party if that action has the effect of hindering the enforcement of the security interest.
2. A person may not destroy, remove, damage, conceal, encumber, transfer, or otherwise deal with property that is subject to a security interest with the intent to prevent collection of the debt represented by the security interest.
3. A person may not, at the time of sale of property that is subject to a security interest, or is described in a certificate provided for under section 41-09-28, make false statements as to the existence of security interests in the property, or as to the ownership or location of the property.
4. A violation of subsection 2 or 3 must be prosecuted as theft under section 12.1-23-02 or 12.1-23-04. Violation of subsection 2 or 3 is a class C felony if the property has a value of more than five hundred dollars, as determined under subsection 6 of section 12.1-23-05. In all other cases, violation of this section is a class A misdemeanor.

Id.

175. N.D. CENT. CODE § 13-01-11 (1991). Section 13-01-11 provides as follows:

Fraudulent conveyance—Penalty. Any person who is a party to any conveyance or assignment of any interest in real or personal property entered into with intent to defraud prior or subsequent purchasers, creditors, or other persons except those with security interest in the property involved, who knowingly participates in such a conveyance or assignment, is guilty of a class A misdemeanor.

fraudulently concealing assets, making of false oaths, or committing bribery, with respect to a bankruptcy proceeding, do not only jeopardize the discharge, but are criminal offenses.[176]

B. SPECIFIC PLANNING SUGGESTIONS/CONSIDERATIONS

1. Begin pre-bankruptcy planning early, if possible, so that transfers are not occurring on the eve of bankruptcy. It is advantageous to have risky transfers *completed* more than a year prior to the bankruptcy, although it is often not realistic to do so.[177]

2. File bankruptcy before judgments are entered against the debtor. Once a judgment is obtained, efforts to levy on assets and satisfy the judgment will probably follow. The debtor may then begin to consider withdrawing funds from bank accounts, placing funds in other accounts, and other actions which increase the risk of being denied discharge when the bankruptcy is filed. If there is no reason to postpone an inevitable filing, then file.

3. If a married couple is contemplating bankruptcy, with spouse A obligated on only a nominal amount of the debt and spouse B obligated on all the debt, consider paying spouse A's creditors, so that spouse A will not need to file bankruptcy. Such a payment should be made outside the preference period, which may be a year in this instance because any payment would reduce the obligation of an insider, *i.e.*, the other spouse, which may extend the preference period from ninety days to one year.[178] Be cautious when considering placing cash in your client's spouse's accounts for protection from creditors prior to filing bankruptcy.[179]

4. If excess cash is available, pay nondischargeable taxes or other potentially nondischargeable debt prior to bankruptcy, outside the preference period to prevent payment from being voided by a trustee under § 547 as a preference.[180] Even though

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Id. *See* N.D. CENT. CODE § 13-01-12 (1991) (providing that removing property from a county with the intent to prevent a levy or disposing of property to prevent its use for payment of debts is a Class A misdemeanor.)

176. *See* 18 U.S.C. § 152 (1988).

177. *See* 11 U.S.C. § 727(a)(2)(A) (1988).

178. *See* 11 U.S.C. § 547(b) (1988); Levit v. Ingersoll Rand Fin. Corp. (*In re* V.N. Deprizio Constr. Co.), 874 F.2d 1186, 1200-01 (7th Cir. 1989) (holding that if debts are guaranteed by an insider creditors can be required to disgorge as preferences payments received up to one year before bankruptcy.)

179. *See* Commercial Nat'l Bank v. Kindorf (*In re* Kindorf), 105 B.R. 685, 689 (Bankr. M.D. Fla. 1989) (determining that intent to hinder, delay and defraud creditor was inferred from transfer of income from wages, distributions and gifts to wife who held for his benefit and from failure to disclose relevant information in Statement of Affairs and Schedules).

180. *See* 11 U.S.C. § 523(a)(7) (1988); Begier v. I.R.S., 496 U.S. 53, 67 (1990) (holding that payment of outstanding trust-fund taxes from debtor's general accounts prior to

nondischargeable taxes may receive priority treatment in a Chapter 7 and ultimately be paid from the estate, administrative expenses may deplete any funds which go into the estate from the debtor.[181]

5. Advise clients against transferring exempt property prior to bankruptcy under suspect circumstances or for less than adequate consideration, such as a homestead interest to a spouse, because the effect of this transfer is to render exempt assets nonexempt after recovery by the trustee.[182]

6. Make accelerated payments on the mortgage on a homestead or acquire a homestead if debtor does not have one. This is the safest method of using cash and proceeds from sale of nonexempt assets, given the current state of the law.[183]

7. Acquire or increase other exempt assets, if the transfers appear to be allowable given the current state of the law. Do not acquire exempt property with borrowed money or money being held for another person without discretionary use of the funds, because this may give rise to a nondischargeability claim for embezzlement.[184]

8. If the debtor-client is a principal in a corporation, advise that client that liability arising from commission of tortious acts while acting for corporation, such as conversion of secured collateral, creates individual liability which may not be discharged in an individual bankruptcy proceeding.[185]

9. Caution clients against incurring credit card debt when

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bankruptcy were not transfers of property of the debtors and therefore not avoidable as preferences).

181. *See* 11 U.S.C. § 507(a)(7) (1988). Another risk in hoping that taxes will be paid from the estate is that the tax agency to which the debtor is obligated may not be willing to wait until the estate is closed to determine if it will be paid, and may continue to pursue the debtor for collection.

182. *See In re* Crosier, 132 B.R. 224 (Bankr. D.N.H. 1991); 11 U.S.C. § 522(g) (1988).

183. *See supra* notes 99-110 and accompanying text.

184. *See* 11 U.S.C. § 523(a)(4) (1988); First Nat'l Bank v. Phillips (*In re* Phillips), 882 F.2d 302, 304 (8th Cir. 1989) (finding that embezzlement was not established where funds received and spent were corporate debtor's subject to a security interest of creditor); Belfry v. Cardozo (*In re* Belfry), 862 F.2d 661, 663 (8th Cir. 1988) (concluding that obligations which were "sufficient to support a claim of embezzlement are ones which make the debtor's discretionary use of the payment, prior to complying with the obligations, improper."); Kagnas v. Robie, 264 F. 92, 93-94 (8th Cir. 1920) (denying a homestead exemption because the debtor bought merchandise on credit immediately prior to bankruptcy and used the proceeds from the sale of the merchandise to buy a homestead, rather than pay suppliers).

185. *See* Ford Motor Credit Co. v. Owens (*In re* Owens), 807 F.2d 1556, 1559 (11th Cir. 1987) (finding that the debtor was personally liable for a corporate obligation where the debtor made a decision to dispose of the corporation's cars without turning the proceeds over to secured creditor); *Phillips*, 882 F.2d at 305 (concluding that willful and malicious conversion of collateral proceeds was not established because debtors sincerely believed they would be able to repay creditor).

having financial problems, because the obligations may not be dischargeable, particularly if used to incur luxury items or if debtor knows that he or she probably will be unable to repay the obligation.[186]

10. Do not spend money lavishly before bankruptcy on expensive trips, parties, gambling or similar purposes which evidence a disregard for creditors.

11. If exempt assets are acquired prior to bankruptcy, do not dispose of the assets soon after a bankruptcy filing, as this may be indicative of acquiring the assets for the purpose of parking cash and not in furtherance of the policies underlying enactment of exemption legislation.[187]

12. Withdraw funds from accounts at creditor banks (provided that the accounts are not lock-box or collateral proceed accounts) and open accounts with banks which are not creditors. This safeguard will prevent the creditor bank from exercising its offset rights if it becomes concerned that its credit is at risk.

13. If bank accounts are held jointly between two people who each contributed to the account, and one person does not

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186. 11 U.S.C. § 523(a)(2)(C) (1988) (finding that debts owed to a single creditor exceeding $500 for luxury goods incurred within forty days of an order for relief under the Bankruptcy Code or cash advances of consumer credit on an open-ended credit plan within twenty days of the order for relief are presumed nondischargeable); *see* Norwest Bank Iowa, N.A. v. Larson (*In re* Larson), 136 B.R. 540, 544 (Bankr. D.N.D. 1992) (finding credit card debt incurred in Chapter 11 by business debtor did not equate with intent to defraud); Citicorp Credit Serv. v. Hinman (*In re* Hinman), 120 B.R. 1018, 1021 (Bankr. D.N.D. 1990) (enumerating list of factors from which courts may infer requisite intent in cases of credit card fraud).

In *Hinman*, Judge William A. Hill shared his philosophy on credit card debt, which is sound advise for all debtors or potential debtors, in or out of bankruptcy.

> There are some who place blame for credit card defaults upon the industry and the seeming cavalier manner in which cards are issued to nearly anyone. While the industry may well be far too lax in its card issuance policies, this court does not believe that policy should in any respect lessen the degree of individual financial responsibility to be imposed upon credit card consumers. It is not the issuance or even possession of a card which results in the incredible number of credit card driven consumer bankruptcies. Rather, it is the unbridled and irresponsible use of credit by people who either have no cash flow consciousness in the first place, or who conveniently leave it at the curb side when entering a retail establishment that is at the root of the problem. To place blame on the card issuer is akin to moralizing over the crime of shoplifting by putting the retailer at fault for attractive merchandising efforts and for not stationing armed guards in every isle. Each person must accept responsibility for his or her own actions and be responsible for his or her own pocketbook. It is an unfortunate observation of modern society that the phrase, "I can't afford it" has become relegated to the unconscious mind of the American consumer. It is no dishonor to shop at K-Mart nor is it dishonorable to look at up-scale merchandise and conclude, "I can't afford it."

Id. at 1023.

187. *See* Panuska v. Johnson (*In re* Johnson), 124 B.R. 290, 297-98 (Bankr. D. Minn. 1991).

intend to file bankruptcy, consider splitting the account in half. Each joint holder should use his or her respective share to establish an individual account.

14. If advantageous, possible, and consistent with § 727, continue with patterns of gifting and allocation of wage checks between spouses. Departure from the typical routine may be risky.[188] Complete disclosure of the transfers on the bankruptcy schedules is important. These transfers may ultimately be avoided as fraudulent conveyances because they occurred for less than fair value. However, if the transfers are consistent with a prior pattern, the intent necessary to prevent the discharge may not be established.

15. Ascertain that prepetition checks have cleared when bankruptcy is filed.[189] If they have not, the balance in the account will be considered property of the estate.[190] If the checks clear after bankruptcy, the debtor may be required to pay the estate the value of the cleared checks[191] or the debtor may be denied a discharge.[192]

16. Do not lie or overtly misrepresent assets, financial condition or other factors to creditors prior to filing a bankruptcy, because this will increase the risk of a discharge being denied.[193]

17. Maintain appropriate records which will enable the tracing of all funds at the debtor's disposal for *at least* the one year period prior to bankruptcy. Receipts and an accounting of cash transactions should be kept.[194]

18. Ask clients to consider whether it is possible that any inheritances will be received during the 180-day period following a bankruptcy filing. Inheritances received before a bankruptcy filing become property of the estate, and available for creditors unless permissible transfer into exempt property has occurred. Inheritances received within six months after the bankruptcy filing also become property of the estate.[195] The discharge may be revoked if the debtor knowingly and fraudulently fails to report,

188. *See Yates*, 26 B.R. at 1008-09 (denying husband's discharge because he deposited portion of wage check in wife's account).

189. *See Gepfrich*, 118 B.R. 135, 138-39 (finding that a check issued by debtor for purposes of buying annuity which cleared the day after the bankruptcy filing was an improper post-petition transfer made with the intent to hinder, delay or defraud creditors).

190. *See In re* Lange, 110 B.R. 907, 910 (Bankr. D. Minn. 1990).

191. *Id.*

192. *See Gepfrich*, 118 B.R. at 139.

193. *See supra* notes 73-77 and accompanying text.

194. *See supra* notes 158-65 and accompanying text.

195. 11 U.S.C. § 541(a)(5) (1988).

deliver or surrender such an inheritance to the trustee.[196]

19. If discharge or nondischargeability problems are anticipated, consider filing a Chapter 11 or Chapter 13 petition because it is possible to discharge obligations under a Chapter 11 or Chapter 13 plan which would not otherwise be dischargable under Chapter 7.[197]

C. BANKRUPTCY SCHEDULES PREPARATION

1. Encourage clients to prepare schedules in advance. Mistakes occur when they are prepared at the last minute, without ample time to review or reflect on them.

2. If reported income in the schedules is inconsistent with reported income on the historical tax returns, questions will be raised, and could result in discharge being denied.[198]

3. Counsel should review the statement of income and expenses with the client, to ensure that all income and expenses are included. If expenses are excluded, and it appears that excess income is available, the court or the United States Trustee may move under § 707(b) to dismiss for substantial abuse.[199]

4. Schedule every conceivable creditor. A debt to a creditor is discharged in a no-asset case where there are no assets available for distribution to creditors, even if there is no notice to creditors, provided there is no evidence that the debt was fraudulently incurred or the creditor was intentionally omitted.[200] However, where there are *any* assets available for distribution, debt owing a creditor who is not scheduled or who has not been given other timely notice of the case will not be discharged.[201]

5. All creditors, including those whom the debtor wants to discharge or those whom the debtor does not want to notify, such as credit card companies with whom the debtor wants to maintain a relationship, must be included on the schedule of creditors.[202]

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196. *See* 11 U.S.C. § 727(d)(2) (1988); Watson v. Jackson (*In re* Jackson), 141 B.R. 702, 706 (Bankr. D. Ariz. 1992) (finding that debtor's failure to promptly amend schedules to list the inheritance, supported by the circumstantial evidence of failing to disclose until late in a deposition, evidenced the wrongful intent).

197. *See supra* notes 19-21 and accompanying text.

198. *See* 11 U.S.C. § 707(b) (1988).

199. *Id.*

200. Peterson v. Anderson (*In re* Anderson), 72 B.R. 783, 787 (Bankr. D. Minn. 1987).

201. Duerkop v. Jongquist (*In re* Jongquist), 125 B.R. 558, 560 (Bankr. D. Minn. 1991).

202. *See* Norwest Bank Iowa, N.A. v. Larson (*In re* Larson), 136 B.R. 540, 544-45 (Bankr. D.N.D. 1992) (implying a need for complete schedules but nevertheless discharging debtor of credit card debt incurred in Chapter 11, prior to conversion to Chapter 7, because it found that the debtor overlooked scheduling the debt and because the debtor intended to use credit cards in the Chapter 11 and continue paying on them).

6. Err on the side of being over inclusive in reporting information on schedules.

7. Inadvertent errors on schedules can happen and courts and trustees are generally understanding. However, this is not always the case and counsel should advise the client to exercise great care and diligence in preparing schedules for a bankruptcy filing.[203] Notify the trustee in writing immediately upon becoming aware of errors and amend the schedules, if necessary. A case alleging intentional misrepresentation is more difficult to establish if the debtor or debtor's counsel expose the errors first, as contrasted to the trustee or creditors learning of the errors through independent sources or from the § 341 meeting, before being advised by the debtor.[204]

D. SECTION 341 FIRST MEETING OF CREDITORS

Counsel should review the bankruptcy schedules with the client shortly before the first meeting of creditors so that the client is prepared to discuss any transactions which may raise questions in the minds of the trustee or creditors.[205] Questions should be answered in a thorough, nonevasive manner.[206] A false, material statement made with the requisite fraudulent intent at a § 341 meeting is a sufficient ground for denying a discharge.[207]

E. DEALING WITH THE TRUSTEE OR CREDITORS

In contrast to nonbankruptcy litigation, a debtor's interests are best served in a Chapter 7 proceeding by fully cooperating with the trustee. The trustee, as compared to certain creditors, does not come into the case with heightened emotions. The trustee must simply become satisfied that all assets have been disclosed and that the debtor is entitled to a nondisputed discharge. The most effective way for debtor's counsel to assist in obtaining

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203. *See* Federal Land Bank v. Ellingson (*In re* Ellingson), 63 B.R. 271, 276-77 (Bankr. N.D. Iowa 1986) (finding that debtors' lack of intent to make false oath on schedules was established by conscious approach to preparing schedules and debtors' counsel cooperation with the trustee in disclosing the assets immediately following the first meeting of creditors).

204. *See* Swicegood v. Ginn, 924 F.2d 230, 231-32 (11th Cir. 1991) (denying discharge even though the debtor amended schedules after becoming aware that former wife disclosed unlisted assets to creditor); Dignam v. McMahon (*In re* McMahon), 116 B.R. 857, 862 (Bankr. M.D. Fla. 1990) (noting that "it is well established that subsequent disclosure does not expunge a prior false oath.").

205. 11 U.S.C. § 343 (1988) (providing that the trustee and creditors are allowed to ask questions at this meeting).

206. *See* Armstrong v. Lunday (*In re* Lunday), 100 B.R. 502, 507 (Bankr. D.N.D. 1989).

207. *Id.* at 508.

the discharge is to provide information to the trustee as requested. Failure to provide requested information leads the trustee to conclude that damaging information is intentionally being withheld and may prompt the trustee to object to a discharge. Even if there is no merit to the claim, these cases need to be taken seriously and are expensive to thoroughly defend.

V. CONCLUSION

Improper conduct relative to a bankruptcy proceeding may lead to serious civil and criminal consequences. Creditors and the United States Department of Justice are increasingly investigating and pursuing bankrupcty fraud cases to discourage debtors and debtors' counsel from participating in bankruptcy fraud. Counsel who elect to advise debtors prior to and during a bankruptcy proceeding *must* stay abreast of the law impacting on bankruptcy planning. First and foremost, debtor clients should be advised to be honest with creditors and the court, and to resist the temptation to resort to dishonesty in an attempt to create short-term benefits in response to current financial pressure. Second, debtors should be led to understand that it is not always possible to protect each and every asset from legitimate claims of creditors. A debtor is entitled to a fresh start, not a head start. Debtors are well advised to remember that conversion of exempt and nonexempt assets is generally permissible, but if they become greedy in that process, the discharge may be denied, for "when a pig becomes a hog it is slaughtered."[208]

208. *See supra* notes 88-92 and accompanying text.