Pre-Bankruptcy Planning

Pre-bankruptcy planning, sometimes labeled as bankruptcy exemption planning, addresses the issue of protecting as many assets as possible in the event someone is anticipating filing bankruptcy. An understandably key factor for someone considering bankruptcy is whether or not they will be able to keep all of their possessions. For purposes of this column, the focus is on maximizing the benefits of bankruptcy exemptions, meaning property that is exempt from the reach of creditors. The other aspect of keeping possessions involves the treatment of secured loans such as mortgages and car loans, and that topic is not addressed here.

In bankruptcy, the nature and value of assets are measured as of the date of the bankruptcy filing. In New York, someone filing bankruptcy can choose between the federal bankruptcy exemptions and exclusions {exemptions per 11 U.S.C. §522(d), and exclusions per 11 U.S.C. §541(b)}, and New York State exemptions (C.P.L.R. §§ 5205 and 5206, and Debtor and Creditor Law §§282 and 283). Each choice (Federal vs. State) provides some benefits that the other does not. This column will not address the specific exemptions that are available, and that may be a topic for a later column. Interpreting the statutory rules that define the exemptions generally does not pose any legal issue in the vast majority of consumer bankruptcies. What may become an issue is the conversion of nonexempt assets to exempt assets, or spending away assets, in anticipation of bankruptcy. As a very simple example of the need for planning, if someone has $25,000 in a savings account, and they have no other significant non-exempt assets (or have little equity in other assets), at best they can protect approximately $12,000 from that account. The client usually would not want to lose the balance ($13,000) in exchange for being relieved of their debts, so the discussion becomes whether all the money can be protected. This discussion is bankruptcy planning. In many ordinary bankruptcy cases, some degree of bankruptcy planning is undertaken. In fact, such discussions need to take place to fully represent the client. If relatively small amounts of money are involved, certainly under $10,000, planning is simple and routine. There are several options to consider, including contributing to a retirement account, paying down a mortgage, paying off certain nondischargeable debts like taxes and student loans, making necessary repairs or improvements to house and car, and simply paying living expenses. Repaying family (or business partners) is not an option.

The issue becomes more complex when the unprotected assets have a value of many tens of thousands of dollars, and certainly once they are of over a hundred thousand dollars. In those situations, typically the clients are facing business-related debts far greater than the assets they have.

In significant planning cases, the difficulty is that there is no overall limit for how much nonexempt equity can be converted to exempt equity without drawing some objection to the subsequent bankruptcy case. There are some statutory limitations on particular transactions, including a limitation against acquiring or increasing a homestead interest with actual intent to hinder, delay, or defraud creditors {11 U.S.C. §522(o)}; a requirement to live in the jurisdiction in which you are filing bankruptcy for at least 730 days before you can take advantage of a particular state's advantageous exemption law, most commonly in those states having an unlimited homestead exemption{11 U.S.C. §522(a)(3)(A)}; a potential cap on the value of the homestead acquired within 1,215 days prior to bankruptcy {11 U.S.C. §522(p)}; and a limit on the amount of money that can be funded into an education savings account (ie., 529 account) {11 U.S.C. §541(b)(5) and (6)}. There are a few other specific limitations for persons who committed securities fraud.

Outside of these specific statutory limitations, we are back to gray, but the picture is getting clearer. Under current law, many bankruptcy courts are allowing debtors to convert nonexempt assets to exempt assets even on the eve of a bankruptcy filing, assuming they do not violate one of the specific statutory limitations as noted above. Stemming from dicta in a 2014 U.S. Supreme Court case of Law v. Siegel , 134 S. Ct. 1188 (2014), the general consensus of the courts now is that absent a statutory prohibition against a claimed exemption, the exemption will stand, even if there is some indication of bad faith by the debtor. In other words, the exemptions are there to allow a debtor and debtor's family to protect certain assets, and those exemptions will not be infringed upon in the absence of specific statutory authority.

So if the courts are allowing conversion of assets in anticipation of bankruptcy, what is the problem? The problem is the "good faith" requirement that is infused in every bankruptcy filing. To the extent a bankruptcy judge needs a statute to support a decision, there is statutory authority for either dismissing a case, or denying a proposed plan, "for cause." {chapter 7 cases, 11 U.S.C. §707; chapter 13, 11 U.S.C. §1307 and §1325; chapter 11, 11 U.S.C. §1112 (b)(1)}. "For cause" has repeatedly been deemed to include good faith on the part of the filing debtor. (see In re Piazza 11th Cir. case 12-12899 2013). A good faith analysis is subject to a totality of circumstances standard, which brings us back to the gray.

The discussion of how far someone can go to protect their assets sometimes turns to an old country saying on being greedy: “Pigs get fed, hogs get slaughtered.” Not much guidance there. There are cases that have worked at the situation from the perspective of looking at the societal benefit of the conversion to determine whether a client acted in good faith in trying to protect his or her assets from creditors. For example, did the client use cash to buy a house to provide a home for the client's family? Did the client payoff a student loan? Are they facing bankruptcy caused by a personal tragedy such as an illness that has resulted in a loss of a job?

Debtor's attorneys are, and should be, cautious about counseling clients on conversion of assets in anticipation of bankruptcy. The more aggressive the conversion in terms of amounts and proximity to the case filing, the more risk that the conversion will be challenged and the asset forfeited, or the case dismissed. Particularly in chapter 7 cases, the assigned bankruptcy trustee has a fiduciary duty (and a personal financial interest) in acquiring assets to pay creditors. The trustees are motivated to review a client's conversion of assets. A point I often make is that the mere bringing of a challenge to a client’s bankruptcy case creates tremendous stress and cost for the client, even if they appear to have a strong defense. Remember, the client is bankrupt. How much more can they pay in legal fees to defend their case?

In situations where there are significant assets to protect, many factors should be considered, including indications of fraudulent conduct by the debtor in any regard, the value of the assets, the merit of the benefit to the debtor, the nature of the debts at issue, reasons for getting into debt, and potential prejudice to the creditors. The options available include the same ones listed above in simple cases: contributing to a retirement account, paying down a mortgage, paying off certain nondischargeable debts like taxes and student loans, making necessary repairs or improvements to house and car, and simply paying living expenses.

In an ideal situation, if there is no pressure to file bankruptcy (i.e. no collection activity), then conversion (or spending) of assets can take place over an extended period of time. The longer the delay between the conversion and the filing of bankruptcy, the better. Pre-bankruptcy planning is an extended process involving a thorough review of a client’s assets, and their goals. Suffice it to say that the most common asset that poses a problem in bankruptcy is a liquid asset that is not part of a retirement account. If a client simply does not want to convert a liquid asset into something else in order to position themselves for bankruptcy, then other options for handling the debt can be reviewed. One final and perhaps obvious note is that simply transferring assets without consideration will afford no protection if a bankruptcy is filed within six years of the transfer, because such transfer will be considered a fraudulent conveyance.

If the client does not get too greedy, and they have not committed any fraud, they will probably be just fine. How's that for certainty?

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Debtors' Prison

I am often asked by clients, "Can I go to jail?" The reassuring answer is, "Absolutely not. There are no more debtor's prisons." But, for someone who is dishonest in their petition, jail is an option. Here is this column's teaching moment showing what not to do when seeking relief under the bankruptcy laws.

Mr. Southwood of California would have done well by some pre-bankruptcy planning. He owned a liquor store through a holding company. He received $171,000.00 from the sale of the store, and somehow had the money put into an account in his parents' names. Long before all this money was gone, he filed for chapter 7 bankruptcy, and neglected to disclose the money. He was convicted of multiple counts of fraud related to his bankruptcy, and was sentenced in December 2016 to a year in prison, and restitution of $119,000.00. Hiding assets is never an option.