Life Insurance and Annuities May Insulate Some Assets From Loss In Unexpected Bankruptcy Filings

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Individuals often have long-term financial plans and goals, such as buying a new home, retiring early, or earning greater investment returns. No one usually plans to file for a personal bankruptcy. However, the need to file for personal bankruptcy can arise from a variety of circumstances, and many individuals are more at risk for bankruptcy than they might imagine. (See box on page 29.)

New York State residents faced with this type of unexpected crisis can be better prepared for it if they have made contingency plans using whole life insurance and annuities.

These plans can provide flexibility that is distinct from traditional alternatives to bankruptcy filing, such as repayment plans made through credit counseling services or a debtor's out-of-court workout with creditors. Nor do they involve the eligibility requirements for filing one type of bankruptcy as opposed to another and the respective advantages and disadvantages of each.[1]

The exemption for the cash value of whole life insurance, and to a lesser extent annuities, provides honest debtors with a way to preserve assets when faced with bankruptcy. Assuming that the claim of exemption for such insurance and annuities is not set aside by the bankruptcy court, a debtor can emerge from bankruptcy still in possession of whole life insurance policies and annuities and be free to receive such annuity payments, draw upon the cash value of such policies or maintain the policies for the insurance protection they provide. This will help the debtor achieve a fresh start, which is one of the principal goals of bankruptcy.

Overview of Bankruptcy Process

The filing of a bankruptcy petition creates an estate consisting of the debtor's property wherever located.[2] However, the debtor is allowed to claim certain property as exempt by listing it on a schedule of exemptions and indicating the legal basis supporting such exemption claim.[3]

An exemption is an interest of the debtor in property withdrawn from the estate (and hence from creditors) for the benefit of the debtor.[4] Because New York has "opted out" of the federal exemption provisions applicable to bankruptcy, a New York resident must look to the New York state exemption scheme to determine the permissible exemptions.[5] Unless a party in interest raises a timely objection to a claimed exemption, such property is exempt.[6] (See the box on page 30 for a summary of major New York exemptions.)

Because the majority of individual bankruptcy filings are under Chapter 7 of the Bankruptcy Code,[7] (the "Code"), the focus of this article is on Chapter 7 (liquidation), rather than on Chapter 13 (wage earner repayment plans) or Chapter 11 (reorganization). In Chapter 7, a trustee is appointed[8] by the U.S. trustee to marshal and liquidate the assets of the estate to raise cash to pay off creditors.[9] To the extent that an exemption claim is successfully challenged by the bankruptcy trustee, the

property claimed as exempt comes into the estate for the benefit of creditors.

Pre-Bankruptcy Exemption Planning

For those who have the financial means, establishing specialized trusts can be an effective means of asset protection. For a number of reasons, however, asset protection trusts may be particularly vulnerable in the event of bankruptcy, or otherwise not suitable for the average debtor. (See the box on page 31.)

Relocation to another state to take advantage of more favorable homestead exemptions also has drawbacks. (See the box on page 34.)

Before bankruptcy, a certain measure of asset protection in the form of pre-bankruptcy exemption planning may be obtained by converting non-exempt assets into exempt assets.[10] In support of such planning, the Second Circuit Court of Appeals has held that "[e]ven the conversion of non-exempt property into exempt property by an insolvent contemplating bankruptcy has been held a transaction not intended to defraud creditors in the absence of extrinsic fraud."[11] Although the Code does not explicitly authorize pre-bankruptcy exemption planning, the holding of the Second Circuit is consistent with the legislative history of the Code.[12]

Exemption for life insurance policies For certain beneficiaries, New York law exempts the proceeds of life insurance policies, including the cash value of whole life policies.[13] The New York Insurance Law provides that:

> If a policy of insurance has been or shall be effected by any person on his own life in favor of a third person beneficiary, or made payable otherwise to a third person, such third person shall be entitled to the *proceeds and avails* of such policy as against the creditors, personal representatives, trustees in bankruptcy and receivers in state and federal court of the person effecting the insurance.[14]

The term "proceeds and avails" is defined in connection with life insurance policies to include:

> death benefits, accelerated payments of the death benefit or accelerated payment of a special surrender value, cash surrender and loan values, premiums waived, and dividends, whether used in reduction of premiums or in whatever manner used or applied, except where the debtor has, after issuance of the policy, elected to receive the dividends in cash.[15]

New York law has generally equated ownership of the insurance policy as equivalent to "effecting" the policy within the meaning of Insurance Law § 3212.[16]

If a beneficiary "effects" insurance on her/his spouse, the proceeds will also be exempt from the spouse-beneficiary's creditors.[17] Thus, where the spouse of the insured is both owner and beneficiary of the policy, the benefits will be exempt from both the claims of the insured's creditors and the spouse's creditors.

The case of *In re Rundlett*[18] illustrates how this exemption works. In *Rundlett*, the debtor was the widow of the chairman of an investment banking firm and had signed certain personal guarantees of her husband's debts before his death.[19] At the time of his death, five life insurance policies were in force covering the debtor's husband's life and naming the debtor as beneficiary. The debtor received the proceeds of these policies totaling $3.5 million and spent approximately $1.2 million before her bankruptcy.

Causes of Personal Bankruptcies

Personal problems: Unemployment, illness, divorce, accidents and excessive debts are the most common problems that lead to personal bankruptcy filings. The normal preventive measures are prudent personal financial habits, adequate savings, and sufficient health, disability, home, auto and life insurance coverage.

Risky businesses: Entrepreneurs, owners of closely held businesses and sole proprietors may incur personal business related liabilities beyond their ability to repay, even though they have prudent personal finances and adequate personal insurance.

Professional malpractice: Corporate officers, directors and skilled professionals (doctors, lawyers, architects, etc.) may incur liabilities connected to their business and professional activities beyond their ability to repay, despite a high net worth, insurance against negligence or indemnification agreements. Judgments can occur in excess of policy limits, indemnitors can become insolvent or file bankruptcy themselves.

Civic and charitable liabilities: Board members and trustees of civic, social and charitable organizations, such as co-op apartments, political action groups, homeowners associations, or religious organizations, among others, may unwittingly incur liability as a result of their volunteer activities. Many such organizations maintain inadequate insurance coverage, or it may not cover the type of liability involved (*e.g.*, defamation, employment discrimination, etc.), or the claim may result in a judgment in excess of insurance policy limits.

Summary of Major Exemptions

Following is a summary of some of the major exemptions that may apply to certain assets when a New York State resident files for bankruptcy.

Homestead $10,000 of equity ($20,000 if married filing jointly).

Various public sector pensions, IRAs, KEOGHs, and private employers' tax qualified pension plans.

"ERISA qualified" plans.

Life insurance—beneficiaries may exempt "proceeds and avails" (including cash surrender value and loan value) from insured's debts. If spouse of insured "effects" the policy, also exempt from spouse's creditors.

Annuity—amount necessary to meet debtor's ordinary financial needs. If purchased within six months of bankruptcy filing, there is a $5,000 cap.

Motor vehicles—$2,400 ($4,800 if married filing jointly).

Wedding ring

Family Bible

In her bankruptcy, the debtor sought to exempt the entire $3.5 million in insurance proceeds. The bankruptcy court had found that only $603,098 in proceeds of two policies that were assigned to the debtor by her husband were entitled to exemption, and that the remaining $2,924,903 was non-exempt. On appeal, the District Court reasoned that only the proceeds of two policies assigned to the debtor by her husband were "effected" by the debtor such that they would be exempt from the claims of her creditors.[20] In addition, the ruling was based on the fact that the debtor's husband had purchased four of the five insurance policies, while his company had purchased the fifth policy. Regarding the policy taken out by the husband's company, the District Court upheld the bankruptcy court's ruling that where a corporation takes out an insurance policy on the life of a shareholder, the shareholder's wife cannot be regarded as having effected the insurance.[21]

Life insurance policies, to the extent of their cash or surrender value while the insured is alive and the death benefit proceeds after the insured's death, are subject to federal estate and gift taxes if the policies are owned by the insured, her/his spouse or another individual. An irrevocable transfer of an existing life insurance policy to a life insurance trust can serve both to exclude the policy and its proceeds from the debtor's bankruptcy estate, and exclude the policy from the debtor's estate for federal estate and gift tax purposes. If the debtor lives for three years after transferring ownership of an existing life insurance policy on her/his life to a qualified trust,[22] the proceeds will avoid estate taxation both at the debtor's death and at the death of her/his spouse. Instead, the life insurance is taxed at its value at the time it is given to the trust, when its value may be fully or partially sheltered from gift tax by the $10,000 annual exclusions available to the debtor and her/his spouse. In addition, if the trustee of the insurance trust is the applicant for and the original owner of a new policy on the debtor's life, the death benefit paid on the new policy will not be subject to estate tax at the debtor's death, even if he/she dies within three years after the policy was purchased.

Purchase of annuities At first glance, New York appears to provide a potentially unlimited exemption for annuities,[23] regardless of whether the debtor is in bankruptcy. The law provides that when a debtor pays the consideration for an annuity contract, the annuity contract and "benefits, rights, privileges, and options" thereunder due or prospectively due, are not subject to execution.[24] A judgment debtor/annuitant may only be compelled upon court order to "pay to a judgment creditor . . . a portion of such benefits [under an annuity contact] that appears just and proper to the court, with due regard for the reasonable requirements of the judgment debtor and his family, if dependent upon him."[25] Thus, under New York state law, as a matter of debtor-creditor law, annuities can be a useful asset protection device for residents who may be faced with adverse money judgments.

However, in bankruptcy the debtor will be allowed only a $5,000 exemption if the annuity contract was "initially purchased by the debtor within six months of the debtor's filing a petition in bankruptcy" and "not purchased by application of proceeds under settlement options of annuity contracts purchased more than six months before the debtor's filing a petition in bankruptcy or under settlement options of life insurance policies."[26]

Thus, if an annuity is purchased as a pre-bankruptcy exemption planning device within six months before a bankruptcy filing, a debtor will be limited to the $5,000 exemption. If purchased more than six months before a bankruptcy filing, depending upon the "reasonable needs of the judgment debtor and his family, if dependent upon him," the debtor may be able to claim the entire annuity as exempt.[27] However, in the face of an objection, the bankruptcy court would then determine what amount of the annuity should go to the debtor's

bankruptcy estate for the benefit of creditors and what amount should remain property of the debtor.[28]

Transfer Issues

A fraudulent transfer cause of action under the Code essentially requires either actual fraud[29] or that the debtor, while insolvent, received less than reasonably equivalent value for the transfer.[30]

Under the Code, insolvency is defined as "the sum of . . . debts greater than all of such entity's property, at a fair valuation" exclusive of any fraudulently transferred or concealed property, or exempt property.[31] A trustee in bankruptcy can bring an action to set aside a fraudulent transfer under New York law,[32] with a six-year reachback period,[33] rather than the one-year reachback period contained in the Code.[34]

The Second Circuit Court of Appeals has held that a transfer before bankruptcy of non-exempt assets does not *ipso facto* compel the conclusion that there was an actual intent to hinder, delay, or defraud creditors; rather, intrinsic evidence of an actual intent to hinder, delay, or defraud creditors must be established beyond the mere fact of the transfer.[35] Lawful exemption planning is permissible. (See the box on page 37.)

In addition, assuming the debtor is not insolvent, the transfer of assets as part of estate planning or tax planning may avoid characterization as a fraudulent conveyance.

Denial of discharge issue One of the main goals of a personal bankruptcy is to obtain a discharge of indebtedness.[36] Although most unsecured obligations are subject to discharge, the Code provides that certain classes of obligations are automatically excepted from discharge[37] or are excepted from discharge upon order of the bankruptcy court.[38]

A debtor may also be denied a discharge in bankruptcy of all obligations, if there was a fraudulent concealment of assets[39] within one year before the bankruptcy petition was filed[40] or one year afterward.[41]

In the case of *In re Carletta*,[42] husband and wife joint debtors residing in New York, on the advice of counsel, used non-exempt cash and a tax refund to purchase two universal life insurance policies for initial premiums of $3,500 and $4,062 respectively. A creditor filed a complaint in their bankruptcy seeking to deny the debtors' discharge pursuant to Code § 727(a)(2)(A).[43] The debtors denied that they made the transfers with actual intent to hinder, delay, or defraud a creditor.[44] The bankruptcy court ruled that no intent to hinder, delay or defraud creditors was present, reasoning as follows:

> Debtors did not engage in sharp dealings, act in a secretive manner or make misrepresentations to creditors. Debtors' pre-bankruptcy planning was not accompanied by concealment or conduct calculated to mislead creditors. Debtors clearly revealed their actions and simply followed counsel's advice in effectuating their rights of exemption as set forth by the New York legislature. . . . It is not unusual for debtors to convert sub-

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Offshore Trusts Not Viable for Average Debtors

Establishing a domestic or offshore trust can be an excellent means of asset protection and estate planning. But it is not foolproof.

Funds in a self-settled trust are not beyond the reach of creditors under New York law,[1] only a trust for the benefit of someone other than the debtor would provide protection.[2]

The transfer of a fund to establish such a trust could potentially be set aside as an actual or constructive fraudulent conveyance[3] up to six years after the transfer.[4]

Also, even if the offshore jurisdiction does not recognize U.S. judgments,[5] a U.S. bankruptcy court can use civil or criminal sanctions against the debtor and thereby compel the debtor to return the offshore trust's assets to the U.S.[6]

Finally, the debtor may incur substantial legal and administrative costs associated with establishing and maintaining offshore entities.[7]

1. N.Y. Estate Powers & Trusts Law § 7-3.1(a); *Dillon v. Spilo*, 275 N.Y. 275, 279 ("[i]t is only where a third party establishes the trust that the income of the beneficiary may not be reached to satisfy claims of creditors"); *see also In re de Kleinman*, 172 B.R. 764, 772 (Bankr. S.D.N.Y. 1994).
2. *Sattin v. Brooks*, 217 B.R. 98 (Bankr. D. Conn. 1998) (where debtor transferred property to his wife within one year prior to involuntary bankruptcy filing against him and his wife, she had established offshore trusts of which husband was beneficiary, property so transferred determined to be property of the debtor's bankruptcy estate).
3. Under either bankruptcy law (United States Code title 11 § 548) or state law (N.Y. Debtor and Creditor Law §§ 273-277) *et seq.*).
4. N.Y. Civil Practice Law and Rules § 213.
5. Eric Henzy, *Offshore and "Other" Shore Asset Protection Trusts*, 32. Vand. J. Transnat'l L. 739, 741 (May 1999) ("[T]he typical offshore jurisdiction does not recognize foreign judgments.").
6. Federal Rules of Bankruptcy Procedure 9020.
7. Eric Henzy, at 740 ("Attorneys specializing in offshore trusts typically charge as much as $18,500 to set up a trust and several thousand dollars each year for maintenance of the trust.").

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> stantially all of their assets into exempt property on the eve of bankruptcy. For the Court to render a per se rule that this is sufficient extrinsic evidence for a finding of actual intent to defraud would effectively swallow Code § 727(a)(2).[45]

The *Carletta* court distinguished the case before it from *Norwest Bank Nebraska, N.A. v. Tveten*,[46] in which the debtor was a physician who converted $700,000 of non-exempt property into exempt property on the eve of bankruptcy. The *Carletta* court found that while the amount of non-exempt property converted to exempt assets is relevant to a Code § 727(a) determination, this fact alone is not dispositive, because a holding of fraud is fact-specific in each case.[47]

By contrast, in the case of *In re Portnoy*,[48] the debtor had personally guaranteed a bank loan in excess of $1 million. Less than 17 months later, the debtor transferred substantially all of his assets valued in excess of $700,000 to an offshore trust based on the island of Jersey.[49] More than five years later, the debtor filed a voluntary Chapter 7 petition.[50]

In the debtor's schedules, the debtor in *Portnoy* identified his interest in the offshore trust as being limited to his status as "one of the beneficiaries as determined by the [offshore trust] trustees in their sole discretion."[51] Based on this and other facts, the bank then brought a complaint for denial of discharge pursuant to Code § 727(a)(2)(A) and (a)(4). The bankruptcy court denied the debtor's motion for summary judgment, finding that triable issues of fact existed concerning the debtor's intent in transferring the assets to the offshore trust[52] and concerning whether his failure to list his "control powers" over the trust assets in the schedules to his bankruptcy petition was knowing or reckless.[53]

Although the debtor's transfer of assets occurred outside of the one-year period before a bankruptcy filing specified in Code § 727(a), the court stated that "'continuing concealment' of property will be found to bar the debtor's discharge when he continued to conceal the existence of the property with the intent to hinder, delay, or defraud."[54]

Denial of discharge is most likely to pose a problem in exemption planning involving the purchase of life insurance or annuity contracts where a very large lump sum cash payment is used to acquire life insurance shortly before filing bankruptcy, or a little more than six months before filing bankruptcy in the case of an annuity. The other factor to consider is how much whole life insurance coverage is acquired. To the extent that the total coverage is entirely out of proportion to the debtor's income and anticipated needs of her/his dependents in the future, the risk increases that discharge may be denied.

Rules Covering Homesteads

A homestead is one of the major exemption planning devices available. Although the New York exemption is small compared with the amount allowed in other states, moving to another state is not a viable option for most debtors.

New York protects $10,000 of equity in principal residence.[1] The figure is $20,000 for married debtors filing a joint petition who jointly own their residence.[2]

Florida allows an unlimited homestead exemption for a personal residence.[3]

Texas allows an unlimited homestead of up to 200 acres, outside of a city or town, including a home or business on such land.[4]

Connecticut allows a $75,000 homestead exemption.[5]

There is a six-month waiting period to re-establish domicile for bankruptcy.[6] Many debtors will not want to relocate to another state due to career, personal or family reasons. Exemptions based on relocation to another state for purposes of claiming favorable exemptions have also been denied by bankruptcy courts.[7]

The U.S. Senate and the House have passed bankruptcy reform legislation that proposes to cap permissible homestead exemption at $100,000 in the Senate Bill and $250,000 in the House Bill. When this article went to press, a conference committee was attempting to resolve differences in the bills.

1. N.Y. Civil Practice Law and Rules § 5206(a), made applicable through N.Y. Debtor and Creditor Law Cred. Law § 282, since New York has opted out of the federal exemptions set forth in United States Code title 11 U.S.C. § 522(d) (hereinafter U.S.C.); *See In re Miller*, 103 B.R. 65, 67 (Bankr. N.D.N.Y. 1989).
2. *John T. Mather Memorial Hospital, Inc. v. Pearl*, 723 F.2d 193, 194 (2d Cir. 1983).
3. Florida Constitution article 10, § 4(a)(1) and article 7, § 6.
4. Texas Constitution article XVI, § 51; Texas Property Code § 41.002.
5. Connecticut General Statutes § 52-352b(t).
6. 11 U.S.C. § 522(b)(2)(A) (must be domiciled in the new state at least "180 days immediately preceding the date of the filing of the [bankruptcy] petition, or for a longer portion of such 180 day period than in any other place" before the exemption laws of that state can be utilized).
7. *See e.g., In re Coplan*, 156 B.R. 88 (Bankr. M.D. Fla. 1993); *In re Schwarb*, 150 B.R. 470 (Bankr. M.D. Fla. 1992).

Conclusion

Whole life insurance provides a significant exemption for New York State residents that should not be overlooked in exemption and asset protection planning. In the case of married couples, maximum protection will be gained if each spouse is the owner and beneficiary of a policy on the other spouse. Moreover, life insurance held by an irrevocable trust may be excluded from the debtor's bankruptcy estate and also excluded from the debtor's estate for estate and gift tax purposes.

The greater the time period from the acquisition of such insurance or an annuity contract to the filing of bankruptcy, the less likely that an exemption for such insurance or annuity may be subject to a claim of fraudulent conveyance. The exemption planning transaction may be insulated from being treated as a fraudulent conveyance if the debtor was solvent at the time he/she purchased insurance or an annuity contract and can establish legitimate reasons for the transfer, such as providing for the debtor's dependents in case of her/his disability or death, estate planning or tax avoidance. In this regard, it would be to the debtor's advantage to have the transfer occur as part of a comprehensive estate plan that encompassed tax, estate planning and asset protection goals, beyond merely pre-bankruptcy exemption planning. The participation of counsel specialized in tax and estates, and not just bankruptcy, may aid the debtor in establishing a basis to protect the transfer from avoidance.

In the absence of actual fraud, the transfer generally will not be disturbed if the debtor was solvent at the time, or if the transfer was for fair consideration. However, if the debtor was insolvent at the time of the transfer, there is a risk that a bankruptcy court in hindsight will not agree with the debtor's determination of what constitutes fair consideration, particularly if the debtor had substantial assets.

An underlying message in many of the exemption planning cases, as articulated in the *Zouhar*[55] case, is that "when a pig becomes a hog it gets slaughtered." In exemption planning, particularly when an unlimited exemption is available, such as that for life insurance, a debtor should not be greedy. Rather, the debtor should make a realistic and reasonable assessment of her/his assets, current liabilities, future earning prospects and anticipated future liabilities (such as for dependents, medical needs, and retirement). If the transaction is later challenged, the existence of a well-reasoned, contemporaneous assessment of the reasons for the transfer may help prevent it from avoidance.

Finally, in the event of a bankruptcy filing, assuming that good records are kept regarding the source of the funds used to acquire the exempt asset, the exempt asset is fully described in the schedules to the debtor's petition, the debtor responds truthfully at the 341(a) meeting of creditors, or any other related discovery, the exemption planning transaction should not be grounds for denial of discharge pursuant to Code § 727.

It would be to the debtor's advantage to have the exemption planning transfer occur as part of a comprehensive estate plan that encompassed tax, estate planning and asset protection goals.

1. Individuals are eligible to file for liquidation under Chapter 7 of the Bankruptcy Code, reorganization under Chapter 11, and, subject to having a regular source of income and certain debt limits, repayment plans under Chapter 13.
2. United States Code, Title 11 § 541 (hereinafter U.S.C.).
3. 11 U.S.C. § 522; *See also* Schedule C (Property Claimed As Exempt) to Official Form No. 6 promulgated by the Judicial Conference of the United States.
4. *Owen v. Owen*, 500 U.S. 305 (1991).
5. 11 U.S.C. § 522(b)(1); N.Y. Debtor and Creditor Law § 284 (hereinafter N.Y. Debt. & Cred. Law); *see In re Kaufman*, 68 B.R. 391, 393 (Bankr. S.D.N.Y. 1986).
6. 11 U.S.C. § 522(*l*). Such objection must be brought within 30 days after the conclusion of the meeting of creditors or the filing of an amendment to the list. Federal Rules of Bankruptcy Procedure 4003(b). The Supreme Court has held that the trustee may not contest the validity of a claimed exemption after the expiration of the 30-day period, even if the debtor had no colorable basis for claiming the exemption. *Taylor v. Freeland & Kronz*, 503 U.S. 638 (1992). Some courts have called this "exemption by default." *See, e.g., In re Morgan*, 149 B.R. 147 (9th Cir. BAP 1993).
7. 11 U.S.C. § 701-766.
8. 11 U.S.C. § 701.
9. 11 U.S.C. § 704(1). Such trustee also has extensive powers to avoid many types of transfers made prior or subsequent to bankruptcy filing. *See* 11 U.S.C. §§ 544, 545, 547, 548, 549, 553(b), and 724(a).
10. *See In re Carletta*, 189 B.R. 258, 261 (Bankr. N.D.N.Y. 1995) (pre-bankruptcy exemption planning "is a strategy whereby financially besieged debtors liquidate non-exempt assets and use the proceeds of that liquidation to purchase exempt property prior to filing a bankruptcy petition.").
11. *Schwartz v. Seldon*, 153 F.2d 334, 336 (2d Cir. 1945).
12. *See* H.R. 595, 95th Cong. (1977); S. 989, 95th Cong. (1977); 1978 U.S.C.C.A.N. pp. 5787, 5862, 6317.
13. N.Y. Debt. & Cred. Law § 282.
14. N.Y. Insurance Law § 3212(b)(1) (hereinafter N.Y. Ins. Law) (emphasis added).

15. N.Y. Ins. Law § 3212(a)(1).
16. *In re Rundlett*, 153 B.R. 126, 129 (Bankr. S.D.N.Y. 1993), *citing to Kaufman v. New York Life Ins. Co.*, 32 A.D.2d 79, 299 N.Y.S.2d 269, *aff'd* 26 N.Y.2d 878, 309 N.Y.S.2d 929 (1970).
17. *See In re Bifulci*, 154 F. Supp. 629, 631 (S.D.N.Y. 1957).
18. *Rundlett*, 153 B.R. 126.
19. *Id.* at 128.
20. *Id.* at 129, *citing to* N.Y. Ins. Law § 3212. *See also In re Mata*, 244 B.R. 580 (Bankr. W.D.N.Y. 1999) (where husband and wife file a joint case under § 302 of the Bankruptcy Code and is owner of a life insurance policy covering the owner's life, the policy is not exempt from claims of the spouse's creditors).
21. *Id.* at 132.
22. Section 2035 of the Internal Revenue Code of 1986, as amended, 26 U.S.C. § 2035. A life insurance trust is generally far simpler and cheaper to establish and maintain than an offshore trust. *See generally* Howard Zaritsky, Tax Planning For Family Wealth Transfers, § 11.04[2] at 11-24 (1997).
23. Defined as "any obligation to pay certain sums at stated times, during life or lives, or for a specified term or terms, issued for a valuable consideration, regardless of whether such sums are payable to one or more persons, jointly or otherwise, but does not include payments under a life insurance policy at stated times during life or lives, or for a specified term or terms." N.Y. Ins. Law § 3212(a)(2).
24. N.Y. Ins. Law § 3212(d)(1).
25. N.Y. Ins. Law § 3212(d)(2).
26. N.Y. Debt. & Cred. Law § 283(1).
27. 11 U.S.C. § 522(*l*). Such objection must be brought within 30 days after the conclusion of the meeting of creditors or the filing of an amendment to the list. Federal Rules of Bankruptcy Procedure 4003(b). The Supreme Court has held that the trustee may not contest the validity of a claimed exemption after the expiration of the 30-day period, even if the debtor had no colorable basis for claiming the exemption. *Taylor v. Freeland & Kronz*, 503 U.S. 638 (1992). Some courts have called this "exemption by default." *See, e.g., In re Morgan*, 149 B.R. 147 (9th Cir. BAP 1993).
28. N.Y. Ins. Law § 3212(d)(2).
29. "The trustee may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred on or within one year before the date of the filing of the petition, if the debtor voluntarily or involuntarily - (A) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted." 11 U.S.C. § 548(a)(1).
30. As an alternative to avoidance of a fraudulent transfer based on actual intent to hinder, delay, or defraud creditors, the Code provides that a trustee may avoid transfers of an interest of the debtor in property, made within one year of the filing of the bankruptcy petition, where the debtor, "(B)(i) received less than a reasonably equivalent value in exchange for such transfer or obligation; and (ii)(I) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation; (II) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital; or (III) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured." 11 U.S.C. § 548(a)(1)(B).
31. 11 U.S.C. § 101(32).
32. "[T]he trustee may avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable under applicable law by a creditor holding an unsecured claim that is allowable under section 502 of this title or that is not allowable under section 502(e) of this title." 11 U.S.C. § 544(b). To set aside a fraudulent transfer under New York law, a plaintiff must establish either that an obligation was incurred with actual fraudulent intent (N.Y. Debt. & Cred. Law § 276), or that fair consideration was not received in exchange for such obligation, by a defendant that was insolvent or became insolvent as a result of incurring the obligation in question. N.Y. Debt. & Cred. Law § 273. Fraudulent intent requires a showing of intent to hinder, delay or defraud either present or future creditors. N.Y. Debt. & Cred. Law § 276.
33. The applicable statute of limitations is six years. N.Y Civil Practice Law & Rules § 213.
34. 11 U.S.C. § 522(*l*). Such objection must be brought within 30 days after the conclusion of the meeting of creditors or the filing of an amendment to the list. Federal Rules of Bankruptcy Procedure 4003(b). The Supreme Court has held that the trustee may not contest the validity of a claimed exemption after the expiration of the 30-day period, even if the debtor had no colorable basis for claiming the exemption. *Taylor v. Freeland & Kronz*, 503 U.S. 638 (1992). Some courts have called this "exemption by default." *See, e.g., In re Morgan*, 149 B.R. 147 (9th Cir. BAP 1993).
35. *In re Adlman*, 541 F.2d 999, 1002-1003 (2nd Cir. 1976).
36. *See* 11 U.S.C. §§ 524, 1141, 1328.
37. *See* 11 U.S.C. §§ 523(a)(1)(certain types of taxes); 523(a)(3)(unscheduled debts); 523(a)(5)(divorce related debts); 523(a)(7)(governmental fines and penalties); 523(a)(8)(certain student loans); and 523(a)(9)(death or injury caused by drunk driving).
38. *See* 11 U.S.C. §§ 523(a)(2)(A) and (B)(fraudulently obtained goods, services and loans); 523(a)(2)(C)(debts for "luxury goods"); 523(a)(4)(fiduciary breach, embezzlement); and 523(a)(7)(willful and malicious injury).
39. Where, "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 [property of the debtor]." 11 U.S.C. § 727(a)(2).
40. 11 U.S.C. § 727(a)(2)(A).
41. 11 U.S.C. § 727(a)(2)(B).
42. *See In re Carletta*, 189 B.R. 258, 260 (Bankr. N.D.N.Y. 1995) (pre-bankruptcy exemption planning "is a strategy whereby financially besieged debtors liquidate non-exempt assets and use the proceeds of that liquidation to purchase exempt property prior to filing a bankruptcy petition.").
43. *Id.*
44. *Id.* at 261.
45. *Id.* at 262.

46. 848 F.2d 871 (8th Cir. 1988).

47. *See Carletta,* 189 B.R. 263 (pre-bankruptcy exemption planning "is a strategy whereby financially besieged debtors liquidate non-exempt assets and use the proceeds of that liquidation to purchase exempt property prior to filing a bankruptcy petition.").

48. 201 B.R. 685 (Bankr. S.D.N.Y. 1996).

49. *Id.* at 689.

50. *Id.* at 691.

51. *Id.*

52. *Id.* at 701.

53. *Id.* at 702; *See also In re Pomerantz,* 215 B.R. 261 (Bankr. S.D.Fla. 1997) (denying discharge to debtor who breached contractual agreement to use proceeds from sale of New York home to pay off a debt, and rather used all of the proceeds, shortly after judgment was entered against her in New York, to purchase home in Florida claimed as exempt homestead in subsequent bankruptcy filing).

54. *Portnoy* 201 B.R. at 695-696.

55. *In re Zouhar,* 10 B.R. 154, 156 (Bankr. D.N.M. 1981).

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Ethical Considerations

In this article we have assumed that counsel would only advise their clients to pursue lawful and permissible exemption planning, as opposed to fraudulent transfers of assets on the eve of bankruptcy.

However, we note that at least for now, the state of the law is that those who assist fraudulent transfers, such as counsel, but do not receive any direct benefit from the transfers themselves, are not subject to liability.[1]

We leave for another day a discussion of the ethical and professional responsibility issues associated with pre-bankruptcy exemption planning,[2] but note it is a good practice to provide the client with a letter or memorandum memorializing counsel's exemption planning advice, the reasons for it, and the potential vulnerability of certain exemption claims. Although outside of bankruptcy such correspondence would be privileged,[3] in the event of a bankruptcy filing, such correspondence may not be insulated from discovery by a bankruptcy trustee.[4] Thus, counsel would be well-advised to be circumspect in the preparation of such correspondence and consider while drafting it how it might be viewed and interpreted by the trustee, creditors, or the bankruptcy court.

Stephen Z. Starr, Brian C. Bandler

1. Craig H. Averich and Blake L. Berryman, *Attorney Liability For the Client's Fraudulent Transfer: Two Theories,* 7 J. Bankr. L. & Prac., 495 (July/August 1998).

2. *See* King et al., 1 *Collier on Bankruptcy,* § 8.06(1)(c) at 8-55 (15th ed.) (discussing ethical issues attendant to exemption planning).

3. N.Y. Civil Practice Law and Rules §§ 3101(c), 4503(a).

4. *See In re Foster,* 217 B.R. 631 (Bankr. D. Colo. 1997) (attorney-client privilege passed to Chapter 7 trustee and neither it nor work-product doctrine barred turnover of documents related to pending pre-petition civil litigation commenced by individual debtor) *aff'd in part, rev'd in part,* 188 F.3d 1259 (10th Cir. 1999) (the Circuit Court affirmed the bankruptcy court's decision that the work product doctrine did not apply, however, the court remanded the case back to the bankruptcy court to determine whether the attorney-client privilege applied to the individual documents sought). *But cf. McClarty v. Gudenau,* 166 B.R. 101, 102 (E.D. Mich. 1994) (attorney-client privilege enjoyed by individual debtor did not pass to trustee upon bankruptcy filing); *In re Hunt,* 153 B.R. 445 (Bankr. N.D. Tex. 1992) (attorney-client privilege did not pass to independent trustees under individual debtors' reorganization plans); *see also* Russell, *Bankruptcy Evidence Manual* § 501.7 at 509 (1999) ("It is presently unsettled whether a trustee may waive an individual debtor's attorney-client privilege").