

Developments

IN ASSET PROTECTION AND WEALTH PRESERVATION

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For over a decade, several legal scholars (and our own Jay Adkisson) have warned that the overt anti-creditor nature of asset protection trusts would eventually cause a legislative backlash. Others made similar warnings about the unlimited homestead exemptions given by Texas and Florida.

In this issue, we examine the new Act as it relates to asset protection planning. We also introduce bankruptcy attorney Rick Reynolds, who describes the process for forcing a debtor into an involuntary bankruptcy. Finally, the Report from Quatloosia discusses the new Mortgage Elimination scam that is going around.

The new Bankruptcy Act is the first evidence of that backlash, and constitutes a major legislative earthquake that will forever and significantly change the debtor-creditor landscape.

Editor

What's New:

- Chris Riser to present "Recognizing The Blind Spots In The World Of Partnerships, LLPs, LLLPs And LLCs", July 28, 2005, Greensboro, NC, see http://www.lorman.com/seminars/seminar_details.php?pid=102863

The New Bankruptcy Act

by Jay Adkisson and Chris Riser

Demanded by the major banks, de-rided by consumer groups, passed by the Senate with little debate, passed by the House without amendment, and quietly signed by President Bush, the new Bankruptcy Act has finally arrived.

In the previous Congress, similar sweeping changes to the Bankruptcy Code were passed by both the House and Senate, but died in conference committee. Some suggest that the legislation was allowed to die because Republicans were concerned about its effect in the critical electoral state of Florida. Whatever the political background, here it is.

The new Act makes the most significant changes to our nation's bankruptcy laws in a generation. It will be some years before we discern most of the nuances of the new Act and determine its impact on

debtors. Apparently, Congress had the sense that consumer bankruptcies were spiraling out of control ("Imagine that," we thought, as we shredded another mailbox-load of unsolicited credit card offers). So it responded by enacting major changes to the Bankruptcy Code, including some draconian measures to deter new filings by making bankruptcy more miserable than it needs to be.

Admittedly, the bankruptcy laws needed both procedural updating and some new teeth to deal with abuse. Perpetrators of investment fraud have long been able to protect money in home equity in Texas or Florida by living in mansions while their victims wonder where their retirement savings went. The new Act takes significant measures to prevent that scenario. And, what about your neighbor with the good job who bought the new car and expensive jewelry, and then used the remaining balance on her charge cards to take a Hawaiian cruise right before her

bankruptcy filing? The new Act also targets frequent or abusive filers like her.

Most of the Act goes into effect around October 17, 2005, although a few provisions became immediately effective. As with previous changes to the Bankruptcy Code, there will be a surge in filings leading up to the effective date as debtors seek the current higher level of protection while they can still get it.

We will examine the ways in which the new Bankruptcy Act will have an immediate impact. We also, make some predictions about how asset protection planning might change in its wake.

Overall Effect on Asset Protection

To a large degree, asset protection planning may be characterized as "pre-bankruptcy planning" because bankruptcy has traditionally offered the best "nuclear bomb" solution to eliminate debts. Unfortunately, unless a debtor planned well in advance, bankruptcy usually meant that

the debtor's assets went away too. As renowned California collection attorney Richard Enkelis reminds us, "The very purpose of a bankruptcy proceeding is to marshal the debtor's assets for the benefit of creditors."

Consequently, asset protection involved long-range planning that anticipated a future bankruptcy filing. The potential debtor, though currently not in danger of bankruptcy, would be able to erase his debts, but with careful advance planning, would be able to retain, directly or indirectly, a significant portion of his wealth. The bankruptcy process certainly would be no fun, but it would give the debtor final resolution of his debts and a fresh start – while retaining some significant assets.

The new Act changes things. In fact, it changes the entire asset protection paradigm as it relates to bankruptcy. The new paradigm of asset protection planning is to arrange the potential debtor's affairs so that he may avoid voluntary bankruptcy, and so that creditors will have little incentive to try to force the debtor into an involuntary bankruptcy.

Already an abstruse mix of disciplines and strategies, asset protection planning suddenly has become much more complex. For a person living in a state with an unlimited homestead exemption, like Florida or Texas, or for a person who could move there, asset protection planning was sometimes no more difficult than finding an adequately expensive residence to soak up the value of his assets. For others, the concept of the self-settled asset protection trust was more attractive. Even if they never seemed to work very well, many planners were presenting them as an option. These planning tools now fall to the wayside in favor of more complex plans that comprise the traditional mixed estate planning, business planning, and retirement planning that we have long advocated.

Procedural Issues

Several procedural changes in the Bankruptcy Act may indirectly affect some asset protection planning matters.

Individual debtors are now required to file their last three years' federal income tax returns, upon the request of the judge or a

creditor. As anybody who has engaged in collection litigation knows, individual income tax returns are often a roadmap to the debtor's asset protection plan, since they may disclose the existence of related business entities or trusts, as well as financial accounts and offshore accounts (unless, of course, the debtor fails to accurately report those accounts, which failure may unleash the wrath of the IRS Criminal Investigation Division upon the debtor).

In many ways, the debtor's bankruptcy attorney must become an investigator for creditors. Changes to section 707(b) requires that the debtor's counsel certify that a "reasonable investigation" has been performed, that the debtor's signed documents and schedules are well-grounded in fact, and that the debtor's counsel is unaware of any incorrect information. A violation of this provision may result in a civil fine to the debtor's counsel, and, possibly, criminal penalties. In other words, the debtor's counsel may be required to snitch on the debtor if the debtor's filings aren't exactly truthful.

Individual debtors must undergo credit counseling prior to filing for bankruptcy. Some commentators have suggested that this might inadvertently have eliminated involuntary bankruptcy for individuals, since there is no way to coerce them to undergo credit counseling. However, this ignores that Congress did not change the involuntary bankruptcy provisions of the Code, and there is absolutely nothing to suggest that Congress meant to apply the new mandatory counseling provisions to involuntary bankruptcies. Even if a bankruptcy judge were to reach this result, Congress likely would quickly pass a technical amendment to eliminate any controversy.

The credit counseling provisions mean that a debtor may not be able to file for bankruptcy quickly, as a tactical measure to delay a trial or foreclosure. Instead, the debtor first must undergo months of credit counseling to even qualify to file.

Many provisions in the new Act will have the effect of speeding up creditors' collection efforts. For instance, a debtor can no longer repeatedly file for bankruptcy to trigger the automatic stay of other litigation and collection actions (a common

tactic employed by debtors trying to slow foreclosures or other litigation). Secured creditors and landlords now have more ways to thwart the automatic stay. Creditors will no longer be liable for violating the automatic stay, unless the debtor makes a very specific communication to the creditor in a very specific form.

Homestead

Most significant is the limitation of the state homestead exemption in bankruptcy to \$125,000, regardless of state law providing for a larger or unlimited exemption. This limitation applies to homestead interests that are acquired within a 1215-day (3 years and 4 months) period prior to the filing of the bankruptcy petition. However, if the debtor has a claim arising from violations of federal or state securities law, RICO, fiduciary fraud, or from certain crimes or intentional torts, then the cap is \$125,000 regardless of when the property was acquired. Rollovers of exempt homestead interests are not allowed even if those interests were exempt in both states. Thus, the debtor who moves from Texas to Florida will re-trigger the 1215 day period, despite the fact that both states have unlimited homestead exemptions.

Obviously, it will no longer be possible for debtors to wait until they have been sued to try to move to a state with an unlimited homestead exemption. Not so obviously, financial professionals and corporate officers or directors should now reconsider the idea of maintaining significant equity in their residences; if such a person ends up on the wrong end of a judgment, the debt may be one that will limit the homestead exemption in bankruptcy to \$125,000, regardless of the length of residence in the state.

Self-Settled Trusts

If you create a trust for your own benefit, you have established a "self-settled trust". If the trust instrument contains provisions that prevent your creditors from reaching your interest in trust assets, the trust is known as a "self-settled spendthrift trust" (or, more commonly, an "asset protection trust").

For many hundreds of years, the provisions of self-settled spendthrift trusts designed to protect trust assets from credi-

tors of the settlor/beneficiary were ineffective. Beginning in the 1980's, certain offshore jurisdictions enacted specially-drafted trust laws overriding this longstanding rule of trust law. Foreign asset protection trusts quickly became popular. In 1999, the rush to form offshore trusts slowed a bit after Michael & Denyse Anderson were jailed for several months for their refusal (or inability, depending on the side from which one views the case) to return funds from their Cook Islands asset protection trust. Foreign asset protection trusts became even less attractive the following year when Stephen J. Lawrence was imprisoned for his refusal to turn over assets from his Mauritius asset protection trust. Lawrence was jailed in August, 2000, and remains jailed today.

In the late 1990s, Alaska led the charge of bringing self-settled spendthrift trusts to the U.S., Delaware, Nevada and a few other states soon adopted similar domestic asset protection trust (DAPT) legislation hoping to attract trust business to their states.

In the last few years, DAPTs appear to have overtaken offshore trusts as the asset protection product *du jour*, largely because of heavy marketing by trust companies. The popularity of DAPTs is surprising because their benefits are purely theoretical. There have been no cases validating them.⁵ The laws of most states, including those of the most populous states, prohibit self-settled spendthrift trusts. Indeed, we and many others have predicted that these trusts have little chance of working for debtors in non-DAPT states.

The heavy marketing of DAPTs had the effect that marketing usually has on asset protection strategies – it attracted the attention of the press, and then, the attention of legislators. Although many bankruptcy reform bills bounced around the halls of Congress for several years none of them contained provisions relating to asset protection trusts. This year, however, while the Act was being debated on the floor of the Senate, the New York Times ran an article about DAPTs and how the rich would be able to protect vast amounts of wealth in these trusts while decades-old bankruptcy protections were stripped away from the poor.

The accuracy of the New York Times article was questionable as the bankruptcy courts had in several previous cases involving the foreign variant simply considered the trust to be an agency arrangement instead of a *bona fide* trust, thus including trust assets in the bankruptcy estate. Nonetheless, just before passage of the Act, the Senate tacked on an amendment offered by Missouri Senator Jim Talent which may kill the DAPT business just as it was starting to gain momentum.

Section 548 of the Bankruptcy Code relates to “Fraudulent Transfers and Obligations”. Prior to the New York Times article, the Senate had only slightly modified Section 548 by changing the limitations period from one year to two years and some other minor changes. After the article, the Talent Amendment adds a new subsection (e) to Section 548 as follows:

(e)(1) In addition to any transfer that the trustee may otherwise avoid, the trustee may avoid any transfer of an interest of the debtor in property that was made on or within 10 years before the date of the filing of the petition, if--

- (A) such transfer was made to a self-settled trust or similar device;
- (B) such transfer was by the debtor;
- (C) the debtor is a beneficiary of such trust or similar device; and
- (D) the debtor made such transfer 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, indebted.

Since this provision deals what appears to be a fatal blow to asset protection trusts, it is worthy of more detailed discussion.

The 10-year period is measured from the date of the filing of a bankruptcy petition, and there is no grandfather provision for existing trusts. This is a very significant change from previous law, since the ordinary bankruptcy limitations period was only one year (increased to two years by the new Act), and most states have four-year limitations periods for challenging fraudulent transfers.

Next, this 10-year limitations period only applies to self-settled trusts “or similar devices”. The term “self-settled trust” is easy: It is a trust that you create for your

own benefit. Asset protection trusts are typically self-settled trusts, as are living trusts.

But what about “similar devices”? Could a bankruptcy trustee use the new Section 548(e) to set aside transfers to trusts that are settled by the debtor, in which the debtor has a limited interest, such as a charitable remainder trust or a qualified personal residence trust? If a transfer to a charitable remainder trust were set aside, the (non-dischargeable) tax consequences to the debtor could be disastrous. Depending on the circumstances, the original deduction could be disallowed, and interest and penalties could apply retroactively.

Another concern of “or similar device” goes to certain types of insurance products, such as “Swiss Annuity” type products and variable universal life insurance products that give their purchasers some investment control, access to cash value, and have only the minimum amount of pure life insurance necessary to satisfy IRS requirements. A sophisticated creditor might make a convincing argument that these arrangements are in the nature of self-settled trusts and are colored with insurance only for technical tax purposes, and thus are within the “or similar device” orbit. With the overt marketing of some financial products, such as private placement life insurance, as asset protection tools, it is not difficult to imagine a court accepting an interpretation of Section 548 by a creditor or trustee to set aside transfers involving some of these types of products.

We are not concerned with ordinary life insurance and annuity products falling into the “or similar device” trap, where they clearly are insurance contracts governed by state insurance codes whose issuers are regulated by state insurance commissioners. However, our musings here illustrate the vagueness of the “or similar device” language of Section 548(e) and the potential for its interpretation to encompass many asset protection strategies. It may be some time before we have sufficient case law to be able to say with any certainty that particular strategies fall into or avoid that trap.

It is clear that that the language of Section 548(e) protects future creditors, not just

creditors existing at the time of the transfer. Section 548(e)(1)(D) refers to existing creditors and to those who became creditors “on or after the date that such transfer was made.” Congress clearly intended that Section 548(e) apply for the benefit of creditors who appeared only after the transfer occurred. Nonetheless, many promoters falsely proclaim that there is no fraudulent transfer risk if there are no current creditors’ claims.

While the fact that a person has no claims against him at the time of a transfer certainly is favorable, it is not dispositive. Indeed, the same language referring to future creditors appears in (unchanged) Section 548(a)(1). Similar provisions appear in the Uniform Fraudulent Transfer Act, which expressly protects future creditors in many circumstances.

There have been some suggestions that the “actual intent” language means that a transfer to a self-settled trust can only be set aside if the debtor confesses that he intended to defraud creditors. Of course, no sober debtor would make such an admission if significant wealth was at risk. Thus, Congress used the exact same phrase that appears in Section 4(a)(1) of the Uniform Fraudulent Transfer Act: “actual intent to hinder, delay, or defraud.” The same phrase appears in Section 548(a)(1)(A) and is part of the principal fraudulent transfer provision of the Bankruptcy Code, that was unchanged by the new Act.

Under both the UFTA and Section 548(a)(1)(A), it is clear that “actual intent” does not require a confession by the debtor. To the contrary, “actual intent” long has been proved by circumstantial evidence consisting of certain factors (the “Badges of Fraud”) that would indicate the debtor’s fraudulent intent. So even if a debtor professes innocence and points to substantial non-asset protection reasons for making transfers, the court may still find that the debtor had the “actual intent to hinder, delay, or defraud” if the circumstances tend to indicate that to the judge.

There is also a new subsection (e)(2) that makes it clear that subsection (e)(1) also applies to transfers in anticipation of a judgment or fine, etc., arising from a violation of state or federal securities laws, or

“fraud, deceit, or manipulation in a fiduciary capacity or in connection with the purchase or sale of any security”. Some have misread subsection (e)(2) to infer that the new 10-year limitations period for self-settled trusts applies only to securities fraud or breach of fiduciary duty, etc., but the “includes” language of (e)(2) is purely supplementary and not limiting.

It is important to keep in mind that the bankruptcy courts were in the habit of considering self-settled trusts to be in the nature of agency relationships, and thus were including self-settled trust assets in the bankruptcy estate anyway. There is no 10-year statute of limitation for this, so even those with “old and cold” asset protection trusts may be sadly disappointed in bankruptcy if their overall arrangement gives (direct or, as is the norm, indirect) control over the distribution of trust assets to the settlor/beneficiary.

If settlors of old and cold APTs clearly do not have control over the distribution of trust assets to themselves, the assets of such trusts would not be included in their bankruptcy estates. However, this presupposes at least two things: first, that there are APT settlors who truly have no direct or indirect ability to compel a trustee to make distributions to them; and second, that a bankruptcy trustee and/or judge would resist a likely urge to disregard the trust as an agency relationship in any event.

The effect of new Section 548(e) is that if asset protection trusts were not dead before, they should not now be used as anything like an ordinary asset protection technique. In more circumstances than not, it may now be the precipice of malpractice to recommend an asset protection trust to a client. The rare exception will be for those who establish foreign asset protection trusts and who are willing and able to flee the U.S. before the court enters the inevitable repatriation order.

So ends our survey of what asset protection planning tools will not work under the new Bankruptcy Act. Now we’ll look at what still does work.

State Exemptions

Except for homestead exemptions and self-settled trusts, most state law exemptions are not significantly affected. How-

ever, to take advantage of most state exemptions, debtors must have been domiciled in the state for two years.

Whether you love or hate life insurance and annuities, the truth is that the laws of many states protect these products to one degree or another, with the laws of some states protecting the full cash value of the policies. The protections are little affected by the new Act, other than that the normal fraudulent transfer limitations period is now two years instead of one. Innovative strategies involving life insurance and annuities will doubtless develop to maximize this protection.

The creative use of life insurance and annuity products will continue to move into the asset protection mainstream. Insurance agents already market accounts receivable factoring and financing arrangements in which the proceeds are used for the purchase of an insurance product. Unfortunately, some insurance agents will fancy themselves as asset protection planners, knowing only that their states protect life insurance products, unaware of the myriad of other substantive and procedural law that could affect that protection. Life insurance and annuities provide good opportunities, but considerable planning is needed for them to work.

Life insurance and annuities are often used to fund various retirement plans and other benefits plans, thus in some occasions giving them an extra inherent layer of asset protection.

Pension Plans, Benefits Plans and Retirement Accounts

Although the Bankruptcy Act was fundamentally anti-debtor, certain arrangements that provide for health and retirement needs continue to be protected, and some protections were even enhanced. This reflects the practical policy choice that Congress doesn’t like creditors to be stiffed, but Congress doesn’t like raising taxes to take care of millions of debtors, either.

The new Act makes significant changes to the protection afforded to a debtor’s interest in pension plans, benefits plans, and retirement accounts. The Act provides full exemptions for contributions to (or amounts withheld from pay for) ERISA-covered employee benefits plans, IRC

Section 414(d) government-sponsored employee benefits plans, IRC Section 457 deferred compensation plans, and IRC 403(b) tax-deferred annuities, and state-regulated health plans.

The new Act also provides exemptions for a debtor's interest in qualified retirement plans, whether the debtor elects state or federal bankruptcy exemptions. IRAs and Roth IRAs, up to \$1 million in the aggregate, are exempted. There also are unlimited exemptions for qualified rollover IRAs, SEP IRAs, and SIMPLE IRAs.

Section 541(c)(2) of the Bankruptcy Code continues to bootstrap these protections by excluding from the bankruptcy estate pension and benefit plans established as valid spendthrift trusts under state law. Under bankruptcy law, state law controls what constitutes a spendthrift trust (except as noted above in our discussion of asset protection trusts).

Debtors' Dilemmas

While assets in an ERISA trust should be protected from creditors by the ERISA anti-alienation provisions regardless of contrary state law, IRAs are sometimes given only limited protection under state law. What this means is that to protect his large IRA, a debtor may have to file for bankruptcy. In doing so, however, the debtor may expose assets to creditors that would otherwise be protected by state law.

Relying on the protection of IRAs in bankruptcy may not be a good idea. Nonetheless some financial advisors have been quick to pitch IRAs as the "ultimate asset protection tool," despite the fact that they may not be well-protected by the laws of some states. Furthermore, when the owner of a large IRA (kept as large as possible for its "protective qualities") dies, the IRA may be depleted tremendously by the combined income tax and estate tax (and, possibly, generation-skipping transfer tax) to which the IRA is subject.

Traditional third-party spendthrift trusts (i.e., spendthrift trusts established for beneficiaries other than the settlor) continue to be excellent asset protection tools for the beneficiaries of such trusts. However, the "means-testing" provisions of the new Act designed to force most bank-

rupt debtors into Chapter 13 repayment plans rather than Chapter 7 liquidation should provide additional impetus to tighten up trust-drafting to ensure, when desired, that the distributional rights of a trust beneficiary is not included in means-testing.

What All This Means

As mentioned at the start of this article, the new Act changes the paradigm of asset protection planning. The goal now must be to avoid bankruptcy if at all possible, and there should be planning to avoid an involuntary bankruptcy (see Rick Reynolds' article that follows), for example, by the use of bankruptcy-remote entities to attempt to limit the number of a client's creditors.

While it always has been preferable to conduct asset protection planning well in advance of potential creditor problems, the new Bankruptcy Act makes advance planning critical. The traditional, last-minute remedy of maximizing the homestead exemption has been significantly weakened, and the self-settled asset protection trust has been eliminated as a viable strategy.

Despite these significant changes, many advanced asset protection planning techniques remain unaffected. Planning using ERISA-protected retirement and benefits plans is enhanced under the new Act. Life insurance and annuities are not significantly affected by the new Act. Also untouched are many business strategies involving partnerships, limited liability companies, and corporations. Ordinary, third-party trusts are also largely unaffected by the Act. However all of these strategies require detailed and advanced planning. They cannot be implemented effectively or easily at the last second.

From now on, there will be two categories of debtors: those who plan intelligently in advance and are able to protect significant assets, and those who do nothing or wait until the last second and get picked clean by creditors. With the potential limitation of the homestead exemption at \$125,000, complex residency issues surrounding state exemptions, and potential Hobson's choices between protecting retirement accounts in bankruptcy and other assets outside of bankruptcy, the changes made

by the new Bankruptcy Act mean that even average Americans now must consider their asset protection options. It is no longer planning just for the affluent.

INVOLUNTARY BANKRUPTCIES AS A CREDITOR STRATEGY

by Richard J. Reynolds

Persons interested in asset protection have tried to avoid filing voluntary bankruptcy for obvious reasons, including the transfer of control of their assets to a bankruptcy trustee. The passage of the Bankruptcy Abuse Prevention and Consumer Act of 2005, signed into law on April 20, 2005, with its restrictions on homestead exemptions and the extension of the statute of limitations to go after asset protection trusts for up to ten years, makes the case not to file voluntary bankruptcy more compelling. Since 1978, 11 U.S.C. §303 has governed involuntary bankruptcy petitions. That section has been amended in the new Bankruptcy Act. While most changes under the 2005 Act do not take effect until October 2005, most of the changes relating to involuntary bankruptcy went into effect on April 20, 2005.

Involuntary bankruptcy occurs when a bankruptcy petition commenced by a creditor or creditors against an alleged debtor. It may be commenced only under Chapter 7 or Chapter 11. An involuntary petition cannot be filed against a farmer, a family farmer or a corporation that is not a moneyed, business or commercial corporation.

Certain persons or entities may not be the subject of an involuntary case. For example, an involuntary bankruptcy petition cannot be filed jointly against a husband and wife. *In re Benny*, 842 F.2d 1147, 1149 (9th Cir. 1988). A non-business trust, which is typically used in some asset protection, family or estate planning, is not eligible to file a voluntary bankruptcy, and therefore cannot be the subject of an involuntary bankruptcy. *In re Secured Equipment Trust of Eastern Airlines, Inc.*, 38 F.3d 86 (2nd Cir. 1994); *In re Hunt*, 160 BR 131 (9th Cir. BAP 1993); *In re Kenneth Allen Knight Trust*, 303 F.3d 671 (6th Cir. 2002).

A creditor cannot bring an involuntary Chapter 13 case because the Bankruptcy Code does not allow it. This is interesting because the main thrust of the Bankruptcy Abuse, Prevention and Consumer Protection Act of 2005 is to force more well-to-do individual debtors into Chapter 13 plans of repayment for a period of five years, using their disposable income to pay creditors.

There are two ways under 11 U.S.C. §303 to force an individual, partnership or corporation (which includes, for purposes of the Bankruptcy Code, a limited liability company and a business trust) into an involuntary bankruptcy. The first method is by the filing of the involuntary petition by “three or more entities, each of which is either a holder of a claim against such person that is not contingent as to liability or the subject of a bona fide dispute **as to liability or amount**, or an indentured trustee representing such a holder, **if such non-contingent, undisputed claims** aggregate at least \$12,300 more than the value of any lien on property of the debtor securing such claims held by the holders of such claims.” [The **boldfaced** portions reflect the changes made in the new Act which are currently in effect.]

The second way is if there are fewer than twelve such creditors, “excluding any employee or insider of such person and any transferee of a transfer that is voidable under Sections 544, 545, 547, 548, 549 or 724(a) of this title, by one or more of such holders that hold in the aggregate at least \$12,300 of such claims.” Any general partner can file a petition to force the partnership into involuntary bankruptcy. The failure of all general partners to sign the petition makes it an involuntary petition.

If the alleged debtor contends that an involuntary petition filed by fewer than three creditors is defective because there are twelve or more creditors of that debtor, the debtor is required to file with its answer a list of all creditors with their addresses, a brief statement of the nature of their claims, and the amounts of those claims. Rule 1003(b) of the Federal Rules of Bankruptcy Procedure. If it appears that there are twelve or more creditors, the court is to afford a reasonable opportunity for other creditors to join in the petition.

In other words, a defective involuntary petition can be cured by adding additional creditors. The matter is then set for trial in the event that the alleged debtor contests the filing.

When there are fewer than twelve creditors, the statute excludes as eligible creditors anyone who received a preferential transfer or a fraudulent transfer from the debtor, and “insiders.” An “insider” in the case of an individual includes a relative of the debtor or of a general partner of the debtor, a partnership in which the debtor is a general partner of the debtor, or a corporation of which the debtor is a director, officer or person in control. If the debtor is a corporation, it includes a director, officer, person in control, a partnership in which the debtor is a general partner, general partner of the debtor, or relative of a general partner, director, officer or person in control of the debtor (including, in the case of a limited liability company, a manager or other person in control of the LLC). 11 U.S.C. §101(31).

In order for the creditor(s) to be successful in proving the case, it must be proven that the debtor is “generally not paying such debtor’s debts as such debts become due unless such debts are the subject of a bona fide dispute.” 11 U.S.C. §303(h)(1). Most litigation in involuntary bankruptcy cases occurs when there are three or more creditors, and there is a “bona fide dispute” as to one or more creditors. The addition of the words “as to liability or amount” to 11 U.S.C. §303(b)(1) is a pro-debtor provision. There are few cases in which the liability is contingent, as opposed to disputed. For example, a guaranty of a debt that has not been called is a contingent debt. There are important reasons why a creditor would want to file an involuntary petition. Frequently, a determined creditor will want to use the bankruptcy provisions, such as the fraudulent transfer provisions or the preference provisions, in order to invalidate transfers by the alleged debtor. The bankruptcy court has substantially more power than the state courts to unwind transfers.

There is a dispute in the circuit courts as to whether the requirement that a creditor’s claim be not subject to a bona fide dispute is jurisdictional or not. *See In re BDC 56 LLC*, 330 F.3d 111, 118 (2nd Cir.

2003) (jurisdictional); and *In re Rubin*, 769 F.2d 611, 614-615 & n.3 (9th Cir. 1985) (not jurisdictional but an element to be established to sustain an involuntary proceeding). The burden of proof is on the creditor to establish that its claim is not subject to a bona fide dispute, and with the new Act, the claim cannot be subject to a bona fide dispute as to liability or amount.

It is possible for even an unstayed judgment on appeal to be the subject of a bona fide dispute. *In re Byrd*, 357 F.3d 433, 437 (4th Cir. 2004). In *Byrd*, the judgment was not the subject of a bona fide dispute, but the court noted that a bankruptcy court need not resolve the merits of the bona fide dispute, but simply determine whether one exists.

The courts that have considered this issue have agreed that the standard is an objective one, rather than subjective. For example, the existence of an affirmative defense may suggest that a bona fide dispute exists. The bankruptcy court merely determines whether there are facts that give rise to a legitimate disagreement or whether money is owed, or, in certain cases, how much is owed. *In re Vortex Fishing Systems, Inc.*, 277 F.3d 1057, 1067 (9th Cir. 2001). Put another way, the court must determine whether there is an objective basis for either a factual or a legal dispute as to the validity of the debt. *In the Matter of Sims*, 994 F.2d 210, 221 (5th Cir. 1993).

However, an unrelated counterclaim by a debtor against a creditor does not make the creditor’s claim the subject of a bona fide dispute. The counterclaim must relate to the creditor’s debt. *In re Seko Investment, Inc.*, 156 F.3d 1005 (9th Cir. 1998) (borrower’s counterclaim on a title insurance policy did not render title company’s claim on promissory notes the subject of a bona fide dispute).

Essentially, if one is in the unfortunate position of owing a large debt, and a bankruptcy is not a palatable option, the best one can do is to have more than twelve creditors. The creditors should not be cooperative with the zealous creditor. Even if that creditor or other creditors have their claims knocked out by the court because they were the subject of a bona fide dispute, the creditor can simply buy

other claims or in effect buy the claims by indemnifying the other claimants, provided that it is done timely, and an additional creditor can join the petition to correct the defective involuntary petition. *In re Rimell*, 946 F.2d 1363, 1366 (8th Cir. 1991) 11 U.S.C. §303(b)(2)(c).

The one section governing involuntary bankruptcy petitions that does not take effect until 180 days after April 20, 2005 is the provision section of the Act which will be known as the "Involuntary Bankruptcy Improvement Act of 2005." That provision provides that if the petition is false or contains any materially false, fictitious, or fraudulent statements, and the debtor is an individual and the court dismisses the petition, the court, on motion of the debtor shall seal the records and the court may enter an order prohibiting all consumer reporting agencies from making any consumer report that contains any information relating to such petition. In addition, §157 of Title 18 of the United States Code, which deals with criminal bankruptcy fraud, has been amended by inserting: "Including a fraudulent bankruptcy petition under section 303 of such title."

Debtors that were successful in defeating an involuntary petition have always had the right to request the court to award costs or reasonable attorneys fees, and in the case of any petition or that the petition in bad faith, any damages proximately caused by the filing or punitive damages. Now there will be potential criminal sanctions against overzealous, deceitful creditors.

Conclusion

Changes to the involuntary bankruptcy statute are some of the few pro-debtor provisions in the new Bankruptcy Act. The Act clarifies that a creditor must prove that its debt is not the subject of a bona fide dispute by adding the words "as to liability or amount." The addition of criminal penalties should give aggressive creditors pause. If the creditor wins, an order for relief is entered, and in effect the case becomes a voluntary one under either Chapter 7 or Chapter 11 (the debtor can elect the Chapter under which the case then will proceed). The best case would be to have a poor debtor who has ten legitimate debts to relatives who will not

join in a bankruptcy petition, one debt that is the subject of a bona fide dispute, one valid creditor who dislikes the debtor and one very aggressive creditor who will do anything to the debtor. The aggressive creditor will not have the ability to force that debtor into bankruptcy under those circumstances. However, that scenario would probably require much more luck than most debtors have.

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RECENT CASE ROUNDUP

Conseco Servs, LLC v. Cuneo, No. 04-1995. (Fla. 3d DCA, 03/09/2005).

The Florida Court of Appeal, Third District, held where debtors used nonexempt funds to purchase a Florida home in order to receive the homestead exemption with the intention of keeping the funds from creditors, the homestead exemption nonetheless protects the debtors.

Richard and Ngaire Cuneo participated in a loan program for Conseco, Inc., in which the Cuneos borrowed \$40 million from banks to purchase Conseco, Inc. stock. The Cuneos also executed notes and guaranties for \$15 million in favor of Conseco Services, so that Conseco Services would pay the interest on the \$40 million loan. However, Conseco, Inc., subsequently filed bankruptcy, rendering the Cuneos' share of Conseco, Inc. stock worthless. The Cuneos defaulted on their bank loans and notes to Conseco Services.

Conseco Services brought suit, alleging that the Cuneos fraudulently transferred their assets in order to hinder, delay, and defraud Conseco Services by selling \$8 million of non-Conseco stocks, obtaining a \$2.45 million mortgage on their Connecticut home, and purchasing a \$10.2 million Florida homestead property. Conseco Services asserted an equitable lien based on its accusations that the Cuneos attempted to take advantage of the Florida homestead exemption in order to hinder

their creditors. Conseco Services filed a notice of *lis pendens* on the property, relying on its equitable lien claim. The trial court dissolved the *lis pendens*, ruling that there was no fair nexus between the Florida home and Conseco Services' dispute. The court ordered the Cuneos to notify Conseco Services if they decided to sell or encumber the property. Both parties appealed.

Relying on *Havoco of America, Ltd. v. Hill*, 790 So. 2d 1018 (Fla. 2001), the appellate court affirmed the trial court's decision, ruling that an equitable lien is not appropriate against a homestead property, unless the funds used to purchase the homestead property were fraudulently obtained, and, even if the Cuneos purchased the Florida property in order to hinder, delay, or defraud their creditors, the property still enjoyed the protections of the constitutional homestead exemption.

* * * * *

Anderson v. Michaelson, No. 03-15979 (9th Cir. 03/25/2005)

The Ninth Circuit Court of Appeals ruled that the district court erred in requiring proof of insolvency in order to show fraudulent transfer of assets because the plaintiff claimed that the debtor fraudulently transferred assets with intent to hinder, delay, or defraud pursuant to a statute that required only a showing of intent.

Plaintiff-Appellant Charles E. Anderson ("Anderson"), as Trustee of Painters District Council No. 30 Pension Fund ("Pension Fund") and as Secretary-Treasurer of Painters District Council No. 30 ("Union") sued Celeste Michaelson for fraudulent transfer of assets pursuant to Arizona's Uniform Fraudulent Transfer Act. The Pension Fund and Union had a judgment for \$269,674.51 against Celeste's husband, Kevin Michaelson. When the Pension Fund and Union could not collect the judgment from Kevin, it pursued Celeste, through Anderson, with this fraudulent transfer suit.

Anderson alleged that Kevin made nine fraudulent transfers of property, including wages and real property, to Celeste, in order to avoid paying the Pension Fund and Union.

Anderson's claims were based on A.R.S. §§ 44-1004(A)(2), 44-1005, and 44-1004(A)(1). The district court ruled that three out of the nine transfers were fraudulent pursuant to A.R.S. §§ 44-1004(A)(2) and 44-1005 because Kevin made the transfers after he was rendered insolvent. However, the district court ignored Anderson's § 44-1004(A)(1) claim and refused to find the remaining six transfers fraudulent because the transactions lacked the insolvency element.

The appellate court declared the district court's decision requiring the element of insolvency for the remaining six transfers was an error because the statutory language of actual fraud under § 44-1004(A)(1) does not require that there was insufficient consideration given to the transferor, or that the transferor was insolvent at the time of transfer. The court noted that § 44-1004(A)(1) only requires a showing of the transferor's intent to hinder, delay, or defraud his creditors. Thus, the court remanded the case to district court.

* * * * *

Krausz Puente LLC v. Westall, No. B164989 (Cal.App. 2d, 01/25/2005)

The California Court of Appeal, Second Appellate District, Division Three, affirmed the trial court's decision to set aside transfers from Slam Site and Strategic Alliance Partners, the debtors, to Game Licensing Group, as fraudulent.

Frank Westall and Edward Hilt owned both Slam Site and Strategic, Inc. Strategic, Inc. owned Slam Site and Game Licensing Group (GLG). Slam Site and Strategic entered into a lease for space at a mall with Krausz Puente, LLC. After Slam Site failed to generate enough business, it was unable to pay rent to Krausz. During the course of several years, employees, assets, and equipment were transferred from one company to the other. As a result, neither Strategic nor Slam Site had the financial wherewithal to pay their creditors.

Further, Frank Westall and Hilt, were connected with another company, Cases Ladder, that conducted operations similar to those of Slam Site. Software licensing income that previously would have gone to Slam Site and Strategic was diverted to

Cases Ladder and GLG. Cases Ladder was sold to e-Universe, Inc. Westall and Hilt obtained a significant amount of e-Universe stock in the sale.

Krausz filed suit against Westall and Hilt for breach of contract and fraud among other causes of action, alleging, among other things, that Westall and Hilt were personally liable under an alter ego theory, and that assets were fraudulently transferred from Slam Site and Strategic to Cases Ladder and GLG. Krausz sought to pierce the corporate veil of Strategic, Slam Site, and Cases Ladder, and to have the court impose a constructive trust on the e-Universe stock that Westall, Hilt, and their designees received as a result of the sale of Cases Ladder to e-Universe. Krausz also sought the imposition of a constructive trust upon the proceeds of any past sales of any e-Universe stock by the principals. The trial court imposed a \$4.5 million constructive trust on the e-Universe stock in favor of Krausz.

The appellate court affirmed the trial court's decision to impose the constructive trust, holding that Westall and Hilt were personally liable for the fraudulent transfers from Slam Site and Strategic pursuant an alter ego theory because Westhall and Hilt exhibited control of the debtor companies; commingled funds; personally used the funds; undercapitalized the debtor companies; diverted the assets of the debtor companies to GLG and Case Ladder; and, failed to follow corporate formalities.

REPORT FROM ABA-RPPT SPRING SYMPOSIUM

by Jay D. Adkisson

The Real Property, Probate and Trust section of the American Bar Association held its annual Spring Symposium the last weekend in April in Washington, D.C. Under the excellent leadership of Ed Koren of Florida, this Symposium was among the best meetings that I've ever attended. The hotels were great, everything ran on time, and the presentations were excellent.

The one thing I do lament is that apparently the RPPT section has abandoned having live committee meetings at its conferences. This is disappointing, as for developing areas of practice like asset protection, these committee meetings are one of the few times for the top planners to get together and openly discuss issues and concerns. It was also one of the few ways to meet other planners.

The April meeting came literally days after passage of the new Bankruptcy Act, and nobody had gotten a real chance to think much about it. Indeed, the fine presentations by Melissa Langa, Denis Kleinfeld, Richard Nenno, moderated by Alexander Bove, on the topic of asset protection trusts were unable to cover the Bankruptcy Act or its implications for planners- because the presentations and materials had to be prepared and submitted long before the new Bankruptcy Act was adopted. As attendee Scott Schwartz told me, "Too bad this seminar isn't two months later so that we could digest the new Act."

Richard Nenno reported that South Dakota has passed DAPT legislation that will go into effect this summer.

Among the many good presentations included the Income and Transfer Tax Planning Group Roundtable, which include a discussion by Ed Manigault of the extremely onerous changes to Circular 230, which governs tax practitioners. Put forth by the IRS to combat the proliferation of technical tax shelters, the effect of Circular 230 will be to deter tax advisors from making even ordinary communications to clients in writing. Or, as somebody suggested, future communications with clients will be done either orally or by hand puppet.

The Wealth Planning Group Roundtable, led by David Neufeld, discussed the life settlements market, as well as the recent proliferation of "no recourse" pre-planned life settlement arrangements. John Skar, the chief actuary of Mass Mutual, discussed these arrangements from the insurance company's viewpoint, and also discussed a recent combined University of Connecticut/Deloitte Consulting study on life settlements. Later, John was nice enough to send me a copy of the study and obtain reprint permission for the

study to be posted on Quatloos. A copy of the study is available at http://www.quatloos.com/uconn_deloitte_life_settlements.pdf and is highly suggested reading.

The next ABA-RPPT Section CLE meeting will be the fall meeting to be held in mid-September in San Francisco, which will be presented (as it was last year) in conjunction with the ABA Tax Section. The asset protection planning committee will make a presentation on charging orders.¹

REPORT FROM QUATLOOSIA

<http://quatloos.com>

by Tony-the-Wonder-Llama

Do you hate paying your mortgage? Yeah, I know that Congress gives you a deduction for the interest and all, but don't you just hate writing a check out for the house that you own?

Well, anytime people hate doing something, odds are that some scam artist will figure out a way not only to make things worse, but also to fatten the scam artist's wallet in the process. Such as it is with the so-called "Mortgage Elimination" scam that is now going around.

Like most scams, the Mortgage Elimination scam has been around for years and years. The last time that it was popular was back in the late 1980s and early 1990s when many Midwestern farmers were losing their plots of land that had been in their family for ages to the evil bankers (or, about as often, the Resolution Trust Corporation) who were foreclosing on their mortgages. Remember the movie "Field of Dreams"? In large part, that movie was about the frustration of the Iowa farmers, and accordingly the foreclosing bankers were portrayed as worse

¹ Ed Koren is a partner of Holland & Knigh LLP in Tampa. Melissa Langa and Alexander Bove are members of Bove & Langa, P.C., in Boston. Denis Klienfeld is a principal of the Kleinfield Law Firm in Miami. Richard Nenno is a Managing Director and Trust Counsel with Wilmington Trust Company. Scott Schwartz is a member of Waldheger & Coyne in Cleveland. Ed Manigault is an associate of Jones Day in Atlanta. David Neufeld is a partner of Markuson Neufeld LLC in Princeton, N.J.

than blood-sucking leeches. John Cougar Mellencamp also did his famous "Farm Aid" concerts around this time.

Never one to miss an opportunity to profit from others' pain, many scam artists flooded the Corn Belt selling various books and kits that espoused various hinky theories about why the farmers weren't really liable under the law to repay the banks on their loans. Many of these theories involved so-called "Allo-dial Title" schemes, while others involved thwarting sheriff sales by repeatedly putting bogus liens on the property. Other popular theories involved the remarkable claim that money isn't really money, and that the banks never actually made any loans in the first place.

These same theories have resurfaced today in what is known as Mortgage Elimination strategies. Essentially, the scam artists advertise for "Mortgage Elimination" or "Debt Elimination" on internet websites, in the Penny Shopper, in the newspaper classifieds or wherever. People who have difficulty in paying their mortgages, and some who are just deadbeats who don't like to repay debts, see these ads and hook up with the scam artists. Then, they buy into a number of schemes.

Most of these scammers have similar *modi operandi*. First, they come up with a bunch of untrue and wild theories about why your average Federal Reserve Notes are not money. To do this, they dig up a bunch of old and out-of-context quotes from old Congressional hearings or Federal Reserve press releases, etc. Then they take the position that whatever it was that the bank advanced to the borrower, it wasn't money; therefore, the loan was both illegal and it is illegal for the bank to require payment of the loan in money.

A similar argument posits that the bank never actually advanced anything, but created "vapor money" out of thin air by making the loan. As crazy as this sounds, it actually appeals to those whose IQs are in the mid-double digits and who never figured out the whole escrow process. Because they never actually touched any money that the bank lent them, these dullards have concluded that no money was ever actually loaned.

It's really kind of fun to argue with those who are drunk of the Mortgage Elimination Kool-Aid, because their theories are so easily thwarted. One has only to ask "So, the seller turned over title of the house to you for free, right?" to get the deer-caught-in-the-headlights stare, followed by more indecipherable babbling about the whole Federal Reserve conspiracy.

Having decided that the original loan on the home was invalid because of the "vapor money" argument, the homeowner then goes down and files what is basically a phony release of the original loan with the county clerk's office. This makes the property appear to be free-and-clear, allowing the homeowner to next fill out a fraudulent loan application that will allow the homeowner to receive a sizeable percentage of the (false) equity in their property. The proceeds from this loan are usually either split with the scam artists, or the scam artists generously allows the homeowner to retain up to \$50,000 of it.

Of course, as soon as the new loan comes due, the homeowner defaults on that loan too. Presumably, the homeowner could repeat the cycle several times, generating several loans for the same equity in the property.

Usually, the first loan goes into default the fastest (if it is not already in default), and the first lender starts the foreclosure process – only to discover the phony release and that another financial institution has attempted to place a priority lien on the property. The first lender then goes into court to set aside the phony release, whereupon an attorney hired by the promoter appears for the borrower and makes every bogus argument to the court, including the "vapor money" argument (more on the attorney in a moment). The goal of this attorney is simply to gum up the works so badly that the first lender will simply throw up his hands and settle the case (using the money gathered from the second loan), and then this tactic is repeated for each lender in turn.

Apparently, the scam artists and those dumb enough to believe in the mortgage elimination scams think that the courts will waste their time in lengthy hearings. But courts can smell a scam like this a

mile off, as a recent federal judge sitting in California did when he commented:

“The Court here has seen the scam at work. Greater bad faith would be hard to imagine. Plaintiffs and their counsel have employed a smokescreen to burden various lending institutions and impose upon them litigation costs in hopes of extracting settlements. The complaint filed in Kenny is exemplary of plaintiffs’ oppressive litigation tactics. In a 35-page, 221-paragraph complaint, plaintiffs made . . . baseless allegations [which] have no basis in fact. They are disjointed, vague and incomprehensible. Fourteen separate complaints containing nearly identical allegations were filed in this district. Moreover, plaintiffs’ ‘vapor money’ theory has no basis in law. It has been squarely addressed and rejected by various courts throughout the country for over twenty years.”²

The court then assessed liability for the lenders’ attorney fees against the promoters and their attorney, jointly and severally. The court also stated that:

“Given the serious and disturbing nature of the allegations set forth above, including the possibility of mail and wire fraud to further an Internet scam upon distressed and vulnerable citizens about to lose their homes, not to mention the lenders, the Clerk shall send a copy of this order to [the] United States Attorney for the Northern District of California.”

Finally, the court referred the conduct of the promoter’s attorney to the State Bar of California for review (and probable disbarment).

Suffice it to say that mortgage elimination scammers may face serious difficulty in finding an attorney to take their case. The bottom line is that mortgage elimination schemes simply do not work, and the promoters of these schemes have never had a single victory against creditors. Of course that doesn’t mean that the promoters haven’t lined their pockets with huge advance fees for their kits and services, though their chances of success are a precisely calculated 0.000%.

Many of those buying into mortgage elimination schemes are people in desper-

ate financial situations who have gotten into debt over their heads, and probably would have had to downsize their houses and lifestyles anyway. These folks might think that they are buying some time, but they have made matters dramatically worse. By making fraudulent filings with the court and bogus loan applications, they have committed perjury and risk prosecution. If that isn’t bad enough, their odds of having their debts now discharged in bankruptcy will be very low, and maybe even impossible with the new Bankruptcy Act discussed above in this newsletter. Usually, those scammed into buying the mortgage elimination kits are also willing suckers for de-tax schemes, which means that, on top of everything else, they are accumulating tax liability that will never be discharged.

The most recent bizarre episode in the mortgage elimination saga is the rumor that has been circulating that one of the most prolific scammers has forced Fannie Mae to their knees and is forcing them to settle cases on a mass basis. Uh, yeah, right . . . right. If anything happens, it will be mass federal prosecutions for loan fraud of both promoters and those who believed in these schemes.

A Must-Have Book on HYIPs

Following the publication of our Developments newsletter for March, we received a few messages from attorneys and other professionals seeking more information on so-called Prime Bank and High-Yield Interest Programs. While this is a subject that we have covered at Quatloos from the very start, we can’t recommend a better source than **Preventing Financial Instrument Fraud**, by Jon Merrett and Paul Renner, prepared by the ICC Commercial Crime Services, the anti-crime arm of the International Chamber of Commerce. This unique reference guide uncovers the mysterious world of High Yield Investment Programs (HYIP) and Financial Products such as Letters of Credit, Bank Guarantees, CD’s, Safe-Keeping Receipts and more as used by Fraudsters. <http://www.fraudbook.com>

This is the book that you need to show your clients why the 20% per week “risk free” deal that is being proposed to them isn’t so.

A REMINDER ABOUT OUR BOOK

“Asset Protection: Concepts and Strategies” by McGraw-Hill & Co., 2004, is available online at <http://bn.com> and <http://amazon.com> and also at most bookstores nationwide.

ABOUT OUR FIRM

Riser Adkisson LLP is a firm practicing in the areas of asset protection, wealth preservation, debtor-creditor litigation, corporations and partnerships, and wills & estate planning.

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IN OUR JUNE ISSUE

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² *Frances Kenny Family Trust v. World Savings Bank FSB*, 2005 WL 106792 (N.D.Cal. Case No. C-04-03724-WHA, Jan. 19, 2005).