Bankruptcy: Exempt Property as the Subject of a Preference or Fraudulent Conveyance Under Section 6 of the Bankruptcy Act

Margaret M. Huff

Follow this and additional works at: http://scholarship.law.marquette.edu/mulr

Part of the Law Commons

Repository Citation
Margaret M. Huff, Bankruptcy: Exempt Property as the Subject of a Preference or Fraudulent Conveyance Under Section 6 of the Bankruptcy Act, 47 Marq. L. Rev. 539 (1964).
Available at: http://scholarship.law.marquette.edu/mulr/vol47/iss4/7
BANKRUPTCY: EXEMPT PROPERTY AS THE SUBJECT OF A PREFERENCE OR FRAUDULENT CONVEYANCE UNDER SECTION 6 OF THE BANKRUPTCY ACT

It is the policy of the Bankruptcy Act that the bankrupt retain some property from his estate to aid him in recovering from his financial embarrassment. A court of bankruptcy looks to the law of the state of which the bankrupt is a resident to determine what property is exempt, and allows the bankrupt to retain the same property that he could reserve were his property subject to levy of execution under the law of that state. The bankrupt asserts his claim to exempt property in schedule 5 of the petition in bankruptcy. Claimed exempt property does not become such merely upon claim, for such claim is subject to examination, determination and allowance in bankruptcy proceedings. The trustee has the right to take and hold possession of the property so claimed until it is released to the bankrupt as exempt. A debtor’s right to claim property as exempt is a privilege which he can waive either expressly or by implication. In a large number of cases, waiver arises from the fact that the debtor failed to claim the exemption at the proper time.

In Wisconsin, property which is exempt from execution is specified by statute: wearing apparel, provisions, income, life insurance, and homesteads are included. The homestead exemption is based on the Wisconsin Constitution and is defined by statute. A resident owner of real property may claim the exemption in his dwelling and its appurtenances whether his interest in it is in fee, less than a fee, or an equity in mortgaged property. The law regarding homesteads in Wisconsin is to be liberally construed, thus while actual physical occupancy has been held to be unnecessary, some use or occupancy is required. Furthermore, while

2 3 REMINGTON, BANKRUPTCY §1280 (5th ed. 1957).
3 Id. §1311.
4 COLLIER, BANKRUPTCY §6.06 (14th ed. 1960).
6 Annot., 82 A.L.R. 648 (1933).
12 WIS. CONST. art. 1, §17: “The privilege of the debtor to enjoy the necessary comforts of life shall be recognized by wholesome laws, exempting a reasonable amount of property from any debt or liability hereafter contracted.”
13 WIS. STAT. §990.01 (14) (1961).
14 Barrack v. Beranek, 113 Wis. 272, 89 N.W. 146 (1902).
16 Jarvis v. Moe, 38 Wis. 440 (1875).
temporary removal will not destroy the homestead, something more overt than a mere hope or intention to return is necessary in order to claim the exemption.¹⁸

As to life insurance policies, a debtor may claim the cash surrender value of any policy on his own life which names another person as beneficiary, unless he transfers it with the intent to defraud creditors.¹⁹

A representative sampling of Wisconsin cases will indicate how these rules are applied. In a garnishment proceeding by a mortgagee against the president of a bank, one Fowler, to whom homestead property had been conveyed subject to the mortgage in order to secure a sum due to the transferee bank, the court held that the property conveyed to Fowler was exempt and could not be reached to satisfy plaintiff's judgment, stating:

... it is impossible to hold that the disposition thus made would render the transaction void, even if colorable, or if it amounted in effect to a voluntary assignment for the benefit of creditors. They (the debtors) had a right to sell and convey their homestead in any way or for any purpose they saw fit. It cannot be predicated of a sale and conveyance or other disposition of a homestead that it is a fraud, and void as against creditors.²⁰

In a state receivership proceeding in which the receiver attempted to recover four lots conveyed by the debtor to his wife without consideration and with the intent to place them beyond the reach of creditors, the receiver was allowed to recover all but one quarter acre; the court stating that "the creditors could not sell the homestead had the title remained in the insolvent debtor. The fact title has passed to the wife puts them in no better situation with regard to the homestead."²¹

In another case, a bank which held four insurance policies as security for a loan completely exhausting their cash surrender values, sued the estate to which the policies were originally payable as beneficiary to collect its claim. The policies had an aggregate face value of $70,000.00. The deceased had substituted his wife and daughter as beneficiaries three months before he committed suicide. The bank contended that the decedent was insolvent at the time he changed the beneficiary, and that such change constituted a conveyance within the Uniform Fraudulent Conveyance Act. The court held that the change of beneficiary did not constitute a fraudu-

---

¹⁸ 1936 Wis. L. Rev. 121.
²¹ Dreutzer v. Bell, 11 Wis. 119 (1860).
lent conveyance because the policies had no cash surrender values at the time the transfer was made.\(^\text{22}\)

In an action by a debtor to replevy books seized by the sheriff on execution, which books had been transferred one year earlier to the debtor's two children without consideration, the court stated:

... the fact that the transfer was without consideration would be deemed a strong, if not conclusive, badge of fraud. But in the case of exempt property which the creditor has no right in law to subject to the payment of his (the debtor's) debts, the rule is otherwise. ... The true test is, was the ... gift valid when made? If the ownership and title then passes absolutely from the debtor, so that he cannot afterwards have or claim any benefit from it, the transfer is un-impeachable on the part of creditors.\(^\text{23}\)

When decisions embodying policies like these are applied in bankruptcy proceedings to determine what is exempt property, it is obvious that the property in question is considered exempt in almost any event. These decisions are also applied in suits where the trustee in bankruptcy is attempting to recover for the benefit of the estate, property which would have been claimed as exempt if it had not been transferred. The theory of recovery in cases of this nature is that such property has been fraudulently conveyed or that the transfer constituted a preference. Such decisions operate to bar the trustee's recovery in these situations. For example, in an early case a debtor mortgaged exempt property as security for a pre-existing debt; the mortgagee had reason to believe that the debtor was insolvent at the time. A few days later the debtor filed his petition in bankruptcy. The trustee attempted to recover the property from the mortgagee, but failed because under state law the property transferred was exempt. Thus it was beyond the reach of creditors and outside of the trustee's grasp.

In a more recent federal decision, a trustee was held unable to recover any portion of three lots transferred without consideration to the bankrupt's son to avoid execution on a personal injury judgment against the bankrupt. The basis of the decision was that the property was the homestead of the bankrupt and "a conveyance of exempt property by an insolvent debtor is not fraudulent as to creditors. The debtors at no time waived or abandoned their homestead exemptions."\(^\text{25}\)

\(^{22}\) First Wisconsin National Bank of Milwaukee v. Roehling, supra note 19.

\(^{23}\) Carhart v. Harshaw, 45 Wis. 340, 346 (1878).

\(^{24}\) Schlitz v. Schatz, 21 Fed. Cas. 699 (No. 12,459) (D. Wis. 1870). The term "transferee" was used in the original Bankruptcy Act, but was later changed to "trustee." The content of the sections was substantially the same.

\(^{25}\) McGhee v. Leitner, 41 F. Supp. 674 (W.D. Wis. 1941).
From an analytical standpoint, the first cases outlined above demonstrate the need to make a prior determination as to what property is exempt under state law. Wisconsin decisions on this issue have held, as has been manifested, that a creditor could not object to a debtor’s transfer of exempt property in an effort to avoid levy of execution, because the creditor had no interest in such property.

The second phase of the problem of transferring exempt property arises when the trustee, who is not limited to the rights of individual creditors in the use of his “weapons,” sets aside a colorable transaction under the Bankruptcy Act as a voidable preference or a fraudulent conveyance. The issue then presented is whether the bankruptcy court should allow the bankrupt to claim his exemptions out of the property so recovered. Originally, there existed a wide split of authority on the issue; some courts allowed the bankrupt to claim the exemptions, while others held that he forfeited his exemption rights in making the fraudulent conveyance or voidable preference. Wisconsin decisions can be found to support both positions; however, the former view has been adopted. An examination of two Wisconsin cases will serve to disclose the varying rationalizations of the courts.

In one case, a husband and wife gave a deed to their daughter in return for a promise of care and support; the husband and wife remained in possession of the property deeded. The husband then filed in bankruptcy, and the trustee brought an action to have the conveyance declared void. He then sold the property to the plaintiff, who sued to eject the husband and wife. The defendants prevailed, the court holding that property fraudulently conveyed is nevertheless considered as belonging to the bankrupt. Thus the judgment in the action to set aside the deed was not binding against the husband and wife because they were not parties to the suit and were not given a chance to claim their homestead exemption. Further, because the property was still the bankrupt’s, the trustee had no right to it, for under the Bankruptcy Act he acquired title to non-exempt property only.26

In another case, it was decided that because the articles in question were sold by the bankrupt to one Hanlon before the filing of the petition in bankruptcy, the bankrupt was not entitled to them whether exempt or not. The sale was found to be made in order to hinder and delay creditors, and thus was void except as to the bankrupt:

The evidence clearly satisfies me that the bankrupt had parted with all his interest in them before the commencement of these proceedings, and that they are not now, and

were not then, his property, but as between Him and Hanlon, they belonged to Hanlon; that the creditors alone can impeach the title of Hanlon for the fraud.\textsuperscript{27}

In 1938 section 6 of the Bankruptcy Act was amended to read:

This Act shall not affect the allowance to bankrupts of the exemptions which are prescribed by the laws of the United States or by the State laws in force at the time of the filing of the petition, or for a longer period of such six months than in any other State: \textit{Provided, however}, That no such allowance shall be made out of the property which a bankrupt transferred or concealed and which is recovered or the transfer of which is avoided under this Act for the benefit of the estate, except that, where the voided transfer was made by way of security only and the property recovered is in excess of the amount secured thereby, such allowance may be made out of such excess.\textsuperscript{28}

The crucial words in the proviso are "under this Act." These words clearly indicate that Congress intended the trustee to employ the weapons of the Bankruptcy Act itself to avoid a colorable transfer. In other words, the trustee should use section 60 if the transfer constitutes a preference. The power of the trustee in bankruptcy under section 60 is neither derived from an existing creditor,\textsuperscript{29} nor dependent upon state law except as to the question of perfecting a security interest in the article involved.\textsuperscript{30} Section 67(d)(3) should be utilized if the fraudulent transfer is made within one year prior to the filing of the petition.\textsuperscript{31} The trustee's power under this section is similarly non-derivative and independent of the construction of the fraudulent conveyance law of any state. This is due to the fact that the Uniform Fraudulent Conveyance Act was in effect enacted as part of the Bankruptcy Act under section 67(2).\textsuperscript{32} The state law of fraudulent conveyances may continue to hamper the trustee in his attempts to use section 70(c) to recover the property for the estate, for that section gives him the powers of a hypothetical lien creditor who could obtain a lien under state law at the date of the bankruptcy.\textsuperscript{33} Since under Wisconsin law a creditor cannot obtain a lien on exempt property fraudulently conveyed, the trustee cannot. The same problem exists under section 70(e).

It is imperative that the proviso of section 6 be interpreted as expressing the intention that federal law supercede state law on the issue of the right to claim exemptions out of property recovered

\textsuperscript{27} \textit{In re} Graham, 10 Fed. Cas. 914 (No. 5,660) (W.D. Wis. 1871).
for the estate in order to effectuate the Congressional purpose in
enacting it. A statement of this purpose is found in the House
Hearings report:

The only important new provision is that, when the bankrupt
has transferred his property, or by way of fraudulent con-
voyance, and the trustee discovers this fact, the bankrupt
cannot impede the trustee’s recovery by claiming exemptions
out of the property so recovered and which he, himself, had
transferred before bankruptcy. It is merely that it is inequit-
able that a bankrupt, who has transferred his property, shall
benefit by the action of the trustee in setting aside that trans-
fer, and take away the fruits of the trustee’s labor.34

In the opinion of Collier, the acknowledged authority on bank-
ruptcy law, the amended section 6 stilled the conflict noted above:

It is clear . . . that wherever the trustee recovers property
transferred or concealed by the bankrupt, or where any trans-
fer can be avoided under the terms of the Act, the bankrupt
will not be allowed to amend his schedules and claim ex-
emptions out of that particular property save in the situation
within the “except” clause.35

Collier’s theory as to the effect of the proviso has been recog-
nized by the several courts in cases decided since 1938. Gardner v.
Johnson36 involved a woman who had acquired a valid homestead
under California law and who thereupon conveyed it to her daugh-
ter three years before her bankruptcy petition was filed. She failed
to claim the property as exempt in the schedules. When she later
attempted to do so the court found that she had waived and
abandoned any claim to the homestead exemption by her failure
to schedule it. This result was contrary to California decisions
holding that a homestead cannot be lost or abandoned by a con-
voyance made for the purpose of avoiding creditors, and that hom-
estead property cannot be the subject of a fraudulent conveyance
since creditors have no claim thereto. The court stated that to hold
other than it did “make(s) the bankrupt the beneficiary of the trus-
tee’s suit to set aside her fraudulent conveyance.”37

The same result was reached in In re Grisanti,38 a case which in-
volved a claim of a $1,000.00 homestead exemption under the law
of Kentucky in property which the bankrupt had mortgaged to his
son. The mortgage was avoided and the property sold. The court
recognized the conflicting decisions on the issue of whether the

34 Mr. Watson B. Adair, member National Bankruptcy Congress, H. R. Rep.
No. 6,439, 75th Cong. 1st Sess. (1937).
36 195 F. 2d 717 (9th Cir. 1952).
37 Id. at 719.
38 58 F. Supp. 646 (W.D. Ky. 1945).
exemption should be allowed the bankrupt out of the proceeds of sale and stated:

'It was Congress' intention in enacting this proviso . . . to clear up this conflict by making the matter uniform throughout the country and not to permit an allowance to be made out of property which is recovered after a preference or fraudulent transfer . . . even if allowed under Kentucky decisions.' 38 [Emphasis added.]

In Branchfield et al. v. McCulley et al. 40 the bankrupt McCulley and his wife deeded their real property to one Allard, Mrs. McCulley's minor son. The alleged consideration was the cancellation of a pre-existing debt of $7235 owed to Allard and represented by a note signed by the McCully's. The trustee in bankruptcy contended that the sole purpose of the deed was to hinder and defraud the defendant's creditors, and that Allard had not in fact given the defendants money on the date the note was executed. Defendant's claimed the realty as their homestead and contended that they had been solvent on the date of the transfer of the deed. The court held that the McCuleys had barred themselves from the exemption which they later sought by signing and recording the fraudulent deed by virtue of the proviso of section 6. 41

In re Rogers 42 involved a bankrupt who orally assigned a life insurance policy to his wife two years before filing his petition in bankruptcy. When he filed it, he failed to claim the cash surrender value of the policy as exempt. The referee found no assignment and ordered the bankrupt to pay him the cash surrender value under section 70(a), or to turn the policy over to the trustee. The bankrupt and his wife filed a petition to review. Two years and four months later, the bankrupt moved to amend his schedules so as to include the policy as exempt for himself. The court denied this motion stating:

The bankrupt did not list the policy deliberately, and assigned with the intent to prevent the trustee and his creditors from knowing. The policy is the bankrupt's and he is not entitled to claim the exemption.
There is no equity in allowing a bankrupt to deliberately fail to mention the insurance policy in the schedule, and contend that he had assigned it to his wife . . . then amend only after an adverse decision by the Referee (in the turn-over proceedings). 43

These cases evidence the disfavor with which the majority of courts now view transfers of exempt property by persons facing imminent

38 Id. at 649.
41 Id., 231 P. 2d at 788.
43 Id. at 300.
bankruptcy. In order to appreciate this viewpoint it is helpful to examine the probable purposes underlying the transfer of exempt property by a debtor. If the debtor retains the exempt property and claims the exemptions, the property or a part thereof will be adjudged to be his. If he transfers the property to a creditor in payment of a debt, that creditor is preferred. If the debtor conveys it to another for cash, the cash becomes part of his estate and gives him no personal advantage. If he transfers it to a member of his family for no consideration, it is a fraudulent conveyance. Thus it appears that to transfer exempt money is actually useless. Having eliminated any result which would be advantageous to the debtor, what motive could therefore prompt the transfer by him of exempt property other than the purpose to somehow defraud his creditors on the mistaken assumption that the property will be safer in the hands of another in the event of his bankruptcy. Pressure exerted by a coercing creditor may be another motivating factor forcing the transfer of property which otherwise would be beyond the creditor's reach. But as this also brings about an undesirable result, neither reason appears to serve the best interests of debtors or creditors.

The case of Rutledge v. Johnson is an example of the minority view on the issue. In that case the trustee sued to recover property transferred for an antecedent debt within four months preceding bankruptcy. At the time of the transfer the property was the bankrupt's homestead. He claimed no exemption in the bankruptcy schedule. The trial court found that all the requirements of a voidable preference were present, but held that it was not voidable because the property transferred was exempt under Oklahoma law. The trustee contended on appeal that the effect of the trial court's judgment was to permit the transferee of the property to claim the exemption, the right to which is personal to the bankrupt and which he alone may claim. The court found that the administrative directions (claiming property as exempt in the schedules) that confine exemption rights to those claimed and set apart upon adjudication apply only to exempt property of which the bankrupt was seized at the time of filing.

While there is much to be said for confining exemption rights to those claimed and set apart upon adjudication, it seems more in consonance with the spirit and purpose of the exemption laws as they are honored in bankruptcy, to hold these administrative directions applicable only to exempt property of which the bankrupt was seized at the time of the filing of bankruptcy. For to hold otherwise would afford creditors a right in exempt property prior to bankruptcy which the law does not give them at the time of the filing or after adjudication.

---

44 270 F. 2d 881 (10th Cir. 1959).
45 Id. at 882.
It is the opinion of this writer that this decision completely disregards the intention of Congress in enacting the proviso of section 6. The court's decision in Rutledge is pronounced as if state law alone is determinative of the issue. This, as has been demonstrated previously, is not the correct position. The court speaks of giving creditors a right in exempt property. This is of course repugnant to the decisions of many state courts concerning exempt property. It was the purpose of Congress to give the trustee, not individual creditors, an interest in exempt property fraudulently or preferentially transferred.

The "administrative directions" in fact do apply only to property held by the bankrupt at the time of filing, for the Act provides that all the bankrupt's property must be turned over to the trustee although the title to exempt property does not pass to him; and thus only the property claimed as exempt by the bankrupt at the time of filing can be set apart by the trustee as exempt. If, as the Rutledge decision suggests, the trustee is barred under state law from recovering property transferred before the time of filing because it would be exempt if the bankrupt had kept it and claimed the exemption, then the result would be to allow the transferee of the property to stand in the shoes of the bankrupt by claiming the exemption for him in an action by the trustee against the transferee. Consequently, the time of adjudication and specification of exempt property "relates back" to the time the fraudulent transfer was made.

There is a strong dissenting opinion in Rutledge written by Judge Breitenstein which touches the practical heart of the problem:

A decision upholding the transfer runs contrary to the rules, recognized by the majority, that the status and rights of the bankrupt, the creditors and the trustee are determined as of the date of filing and that any exemption must be claimed by the bankrupt. Failure to follow these rules favors an aggressive creditor and deprives a bankrupt of the means of rehabilitation which the exemption laws are intended to afford. The fact that the debtor could make the transfer after bankruptcy is, to me, no answer. Before bankruptcy, an honest man strives to prevent the impending disaster. After bankruptcy he attempts to save what he can from the wreck. These simple considerations justify the policy of fixing rights as of the date of bankruptcy and of giving to the bankrupt not to a transferee, the right to claim an exemption.

In summary, it is the opinion of the writer that the majority view which denies to a bankrupt the right to claim an exemption out of property fraudulently or preferentially transferred is the better reasoned position and that it better accomplishes the purpose of the bankruptcy act as a whole.

MARGARET M. HUFF

46 Collier, op. cit. supra note 4.
47 Note 44 supra, at 883.