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CONVERSION OF NONEXEMPT PROPERTY TO EXEMPT PROPERTY ON THE EVE OF BANKRUPTCY IN ARKANSAS*

J. Thomas Hardin**

Difficult economic times have forced more and more people to consider bankruptcy as the ultimate solution to their financial problems.1 Faced with the unknowns of bankruptcy, these people have many fears. Foremost is a concern about what property they will be able to keep. The Bankruptcy Code and Arkansas' exemption laws answer this question for Arkansas debtors. The question and its answer, however, may lead the debtor and his lawyer into risky waters which endanger the effectiveness of the debtor's bankruptcy and raise important ethical considerations for the attorney.

In part, the risk is created by the tension between the two primary purposes of bankruptcy laws: (1) to give the debtor a fresh start by relieving him of debt;2 and (2) to make an equitable and efficient distribution of the debtor's property among his creditors.3 Arkansas'...

* For a related article dealing with Oklahoma law, see Hardin, Bankruptcy Planning: Risks of Converting Nonexempt Property to Exempt Property on the Eve of Bankruptcy, 12 OKLA. CITY U.L. REV. 279 (1987).

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1. This article only considers the conversion of nonexempt assets into exempt assets in the context of a bankruptcy. The exemption statutes, however, also apply to nonbankruptcy proceedings, such as garnishments or executions of judgments outside of the bankruptcy context.

2. Williams v. U.S. Fidelity & Guar. Co., 236 U.S. 549, 554-55 (1915). In Local Loan Co. v. Hunt, 292 U.S. 234, 244 (1934) the Supreme Court citing Williams stated:

This purpose of the act has been again and again emphasized by the courts as being of public as well as private interest, in that it gives to the honest but unfortunate debtor who surrenders for distribution the property which he owns at the time of bankruptcy, a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of pre-existing debt.

See Williams v. Swann, 220 Ark. 906, 251 S.W.2d 111 (1952) (exemptions were enacted for the benefit of distressed debtors).

exemption statutes help achieve the first goal by exempting certain property of individual debtors\textsuperscript{4} from the claims of creditors. Since exempt property is unavailable to satisfy creditor claims, however, the courts must balance the scope of these exemption laws against the second goal of fair creditor distributions.

When attorneys discuss exemptions with debtors on the verge of bankruptcy, they become involved in this balancing act. Once informed about exempt property, a debtor will be tempted to salvage as many assets as possible.\textsuperscript{5} The debtor will likely ask the attorney whether (and, to the debtor most importantly, how) the debtor can purchase, improve or otherwise convert nonexempt property to exempt property before filing. This discussion often occurs on the very eve of bankruptcy, and the decision of whether to convert nonexempt property immediately follows. For the purposes of this article, the term "asset conversion" means the acquisition, improvement, transfer or other conversion of nonexempt property into exempt property.

I. PURPOSES OF EXEMPTIONS AND CRITICISMS

Arkansas' constitutional\textsuperscript{6} and statutory\textsuperscript{7} exemptions further numerous debtor protection goals,\textsuperscript{8} and the Arkansas Supreme Court

\begin{itemize}
  \item \textsuperscript{4} See, e.g., ARK. CONST. art. IX, § 1 ("Personal property exemptions of persons . . . .") (emphasis added).
  \begin{quote}
    [W]hen discussing both collection of the estate and discharge, one should be aware that the debtor and his creditors are engaged in what could be described as a great game. The goal of the game for the debtor is to retain as much property as possible despite the bankruptcy proceeding. The exemption provisions of state and federal law are the most plainly relevant tools for achieving this goal.
  \end{quote}
  \textit{Id.} at 320 (citations omitted).
  \item \textsuperscript{6} ARK. CONST. art. IX, §§ 1 to 10, amended by Amendment No. 22.
  \item \textsuperscript{7} ARK. CODE ANN. § 16-66-218 (1987) lists certain statutory exemptions and cross references numerous others.
  \item \textsuperscript{8} Resnick, \textit{supra} note 3, at 620. In his article, Professor Resnick suggests that historically exemption laws promoted five distinct social policies:
    \begin{itemize}
      \item (1) To provide the debtor with property necessary for his physical survival;
      \item (2) To protect the dignity and the cultural and religious identity of the debtor;
      \item (3) To enable the debtor to rehabilitate himself financially and earn income in the future;
      \item (4) To protect the debtor's family from the adverse consequences of impoverishment;
      \item (5) To shift the burden of providing the debtor and his family with minimal financial support from society to the debtor's creditors.
    \end{itemize}
  \textit{Id.} at 621. See also Sannoner v. King, 49 Ark. 299, 301, 5 S.W. 327, 328 (1887) ("The exemption law is generous and humane") and cases cited \textit{infra} note 9.
\end{itemize}
has repeatedly stated that the exemption statutes are to be liberally construed to effect their intents and purposes.\(^9\) Many exemptions, however, have remained relatively unchanged since their enactment in the early twentieth century, and commentators have criticized some state exemption laws as being obsolete or overly generous.\(^10\)

Prior to enactment of the Bankruptcy Reform Act of 1978 (Bankruptcy Code),\(^11\) federal bankruptcy law incorporated state and federal exemptions by reference.\(^12\) Section 522 of the Bankruptcy Code adopted uniform federal exemptions\(^13\) which answered many of these criticisms by implementing maximum dollar limitations, while providing minimum level exemptions for debtors who lived in states having very restrictive exemptions.\(^14\) As a Senate/House compromise, however, section 522(b)(1) allowed states to affirmatively determine whether federal exemptions would apply as an alternative to their exemptions.

In 1981, Arkansas elected not to incorporate the federal exemptions into Arkansas bankruptcies.\(^15\) Thus, generous, and possibly obsolete, exemptions provided by Arkansas law may enable debtors to keep property beyond the reach of creditors when no social policy is served. For example, the homestead exemption provided by Arkansas' Constitution has no value limitation for the minimum homesteads and may permit debtors to shield 100% of their homestead equity from creditors: \(^16\) $10,000, $100,000 or $1,000,000, there is no limit. Debtors may compound this inequity if they are encouraged or permitted to purchase, improve or otherwise convert nonexempt property into exempt property immediately prior to declaring bankruptcy. Although Arkansas exemption statutes do not directly address this asset conversion process, creditors and courts faced with it across the nation have invoked numerous techniques "to prevent abuses by

\(^9\) In re Stone, 116 F. 35 (E.D. Ark. 1902); Williams v. Swann, 220 Ark. 906, 251 S.W.2d 111 (1952); City Nat. Bank v. Johnson, 192 Ark. 945, 96 S.W.2d 482 (1936); Bunting v. Rollins, 189 Ark. 12, 70 S.W.2d 40 (1934); Pemberton v. Bank of Eastern Ark., 173 Ark. 949, 294 S.W. 64 (1927); Davis v. Cramer, 133 Ark. 224, 202 S.W. 239 (1918).


\(^16\) Ark. Const. art. IX, §§ 4-5 provides 80 acre rural and \(\frac{1}{4}\) acre urban homesteads "without regard to value."
either creditors or debtors." These include: (1) an interpretation of the facts of the exemption claim to determine that the exemption statute does not apply; (2) to the extent permitted by state law, disallowance of the exemption claim for actual fraud or, if a transfer is involved, actual or constructive fraud; and (3) denial of discharge in bankruptcy under section 727 of the Bankruptcy Code for (a) actual fraud in the asset conversion or (b) failure to properly disclose the asset conversion.

Approximately fifty-eight percent of the post-1978 bankruptcy court decisions reviewed for this article and dealing with asset conversions have applied one or more of these techniques against the debtor, with a resulting loss of exemption or denial of discharge. Although not an all-inclusive list of cases, the percentage of disapproval sends a clear judicial signal which debtors and attorneys must not ignore. Consequently, debtors and attorneys considering an asset conversion must carefully consider the boundaries of what the courts will permit.

II. ASSET CONVERSION UNDER THE BANKRUPTCY CODE AND THE PER SE RULE

A. General

Under section 541(a) of the Bankruptcy Code, property of the debtor automatically becomes property of the bankruptcy estate upon

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filing for relief. Section 522 of the Bankruptcy Code, however, allows an individual debtor to exempt certain property from the estate. Since Arkansas has preempted the standard federal exemptions, Arkansas law governs the applicability, interpretation and scope of exemption claims made in an Arkansas bankruptcy.

Procedurally, Bankruptcy Rule 4003 requires the debtor to list all property claimed as exempt on the schedule of assets filed pursuant to Bankruptcy Rule 1007. Exemptions must be claimed by the debtor upon the filing of a voluntary case, or within fifteen days after the filing of an involuntary case, unless an extension of time for filing is granted. Objections to a claim of exemption must be made by the trustee or any creditor within thirty days after the conclusion of the section 341 meeting of creditors. If an objection is made, the bankruptcy court will consider its merits. Consistent with Arkansas' requirement that its exemption statutes be liberally construed, the "objecting party has the burden of proving that the exemptions are not properly claimed."

Challenges to exemptions may be made under sections 547 (Preferences), 548 (Fraudulent Transfers and Obligations) and 544 (Trustee as Lien Creditor and as Successor to Certain Creditors and Purchasers) of the Bankruptcy Code. Most asset conversion cases employ sections 544 and 548 claims rather than section 547 preference claims since many asset conversions do not meet the preference tests of subsections 547(b)(2) and 547(b)(5).

21. In re Reed, 700 F.2d 986 (5th Cir. 1983); In re Jackson, 472 F.2d 589 (9th Cir. 1973); Elliott v. Ostman, 340 F.2d 581 (9th Cir. 1965); In re Olson, 45 Bankr. 501, 504 (Bankr. D. Minn. 1984).
22. Bankr. R. 1007(b). See Official Form 6, Schedule B-4 which requires the debtor to state (1) a description of the type of property, (2) the location and, to the extent required by the claimed exemption, use of such property, (3) the statute creating the exemption and (4) the value of the property claimed as exempt.
23. Bankr. R. 1007(c). See also Bankr. R. 1009(a) which allows the debtor in a voluntary case to amend schedules "as a matter of course at any time before the case is closed."
B. The Per Se Rule

The legislative history to section 522 of the Bankruptcy Code expressly considers asset conversions. Based on 1975 and 1976 hearings, the Senate and House reports observe that:

As under current law, the debtor will be permitted to convert non-exempt property into exempt property before filing a bankruptcy petition. The practice is not fraudulent as to creditors, and permits the debtor to make full use of the exemptions to which he is entitled under the law.\(^{30}\)

This statement appears to strongly support a debtor’s right to convert nonexempt property into exempt property on the eve of bankruptcy. In fact, in several cases\(^{31}\) the debtors apparently relied on little more to justify their actions. Such reliance is misplaced. As is sometimes the case with legislative history, the summary of “current law” given in the Senate and House reports overstates the judicial rule.\(^{32}\) The early case of *Crawford v. Sternberg* more accurately defines the rule as follows:

It is well settled that it is not a fraudulent act by an individual who knows he is insolvent to convert a part of his property which is not exempt into property which is exempt, for the purpose of claiming his exemptions therein, and of thereby placing it out of the reach of his creditors . . . .\(^{33}\)

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32. The bankruptcy court in *Mickelson v. Anderson*, 31 Bankr. 635 (Bankr. D. Minn. 1982) went further. In commenting on the debtor’s reliance on the legislative history set out in the West Publication of the Bankruptcy Code, the court stated as follows:

The course of the legislative proposals which eventually became the Bankruptcy Code was unusual with the result that even Committee Reports are often ambiguous and confusing, often contradictory and sometimes in total error when applied to the end legislative product. The comment quoted from West is subject to those frailties. Examination of the legislative proceedings pinpoints the source of the assertion to be in a letter addressed to Congressman Don Edwards by Bankruptcy Judge Phelps of the Central District of California calling attention to the law apparently prevailing in the Ninth Circuit which permitted such prebankruptcy planning and conversion of non-exempt assets into exempt assets as preliminary to his suggestion that such prebankruptcy planning and conversion of assets should be forfended in the proposed Code. The discussion at the hearing following receipt of the letter was cursory and with no positive indication that such rule of law was universal. Accordingly the West note lacks authority, and the text of the Code does not expressly deal with the question.

33. *Crawford v. Sternberg*, 220 F. 73, 76 (8th Cir. 1915) (citations omitted).
Generally this holding means that "the conversion of nonexempt to exempt property by a debtor is not, in and of itself, a fraud on creditors."\textsuperscript{34} This per se rule was apparently adopted in the 1913 Arkansas Supreme Court decision of \textit{Littleton v. Carruthers-Jones Shoe Co.}\textsuperscript{35} which approved the trade of goods purchased on credit by an insolvent debtor for an exempt homestead. In allowing the transaction, the court adopted the earlier holding of the United States Court of Appeals for the Eighth Circuit in \textit{First National Bank v. Glass}:\textsuperscript{36}

An insolvent debtor may use with impunity any of his property that is free from the liens and vested equitable interest of his creditors to purchase a homestead for himself and his family in his own name. If he takes property that is not exempt from judicial sale and applies it to this purpose, he merely avails himself of a plain provision of the Constitution or the statute enacted for the benefit of himself and his family. He takes nothing from his creditors by this action in which they have any vested right.\textsuperscript{37}

This conclusion is supported by other general legal principles which require that (1) fraud must be clearly shown and cannot be presumed\textsuperscript{38} and (2) fraud cannot be predicated upon an act which a party had a right by law to do.\textsuperscript{39} Courts have also applied these principles to help justify upholding exemptions acquired (or created) on the eve of bankruptcy. For example, one court utilized these principles to approve an exemption acquired through an asset conversion just one day before commencement of the bankruptcy action.\textsuperscript{40}

\textsuperscript{34} See Resnick, \textit{supra} note 3, at 630. For early cases supporting this conclusion see \textit{In re Adlman}, 541 F.2d 999 (2d Cir. 1976); \textit{In re Jackson}, 472 F.2d 589 (9th Cir. 1971); Wudrick v. Clements, 451 F.2d 988 (9th Cir. 1971); Schwartz v. Seldon, 153 F.2d 334 (2d Cir. 1945); Forsberg v. Security State Bank, 15 F.2d 479 (8th Cir. 1926); \textit{In re Dudley}, 72 F. Supp. 943 (S.D. Cal. 1947), aff'd sub nom. Goggins v. Dudley, 166 F.2d 1023 (9th Cir. 1948); \textit{In re Hammonds}, 198 F. 574 (E.D. Ky. 1912); Kelly v. Sparks, 54 F. 70 (C.C.D. Kan. 1893).

\textsuperscript{35} 109 Ark. 493, 160 S.W. 397 (1913).

\textsuperscript{36} 79 F. 706 (8th Cir. 1897).

\textsuperscript{37} \textit{Id.} at 707. In \textit{Littleton} the Arkansas Supreme Court also quotes with approval the language of Jacoby v. Parkland Distilling Co., 41 Minn. 227, 43 N.W. 52 (1889) as follows:

Even if he disposes of his property subject to execution, for the very purpose of converting the proceeds into exempt property, this will not constitute legal fraud. This he may do at any time before the creditors acquire a lien upon the property. It is a right which the law gives him, subject to which every one gives him credit, and fraud can never be predicated on an act which the law permits.

109 Ark. at 496, 160 S.W. at 398.


\textsuperscript{39} See, e.g., Jewell v. Allen, 109 P.2d 235, 237 (Okl. 1940) (citing with approval Sachs v. Blewett, 206 Ind. 151, 185 N.E. 856 (1933), \textit{reh'g denied}, 206 Ind. 151, 188 N.E. 674 (1934)).

\textsuperscript{40} Crawford v. Sternberg, 220 F. 73 (8th Cir. 1915). For other examples of asset conversions within a short time of bankruptcy see \textit{Love v. Menick}, 341 F.2d 680 (9th Cir. 1965) (2
III. BEWARE OF THE PER SE RULE—TECHNIQUES TO CHALLENGE ASSET CONVERSIONS

A. Interpretation of the Facts to Make an Exemption Statute Inapplicable

State law determines the applicability and scope of an exemption claim. Thus, a court can completely avoid the asset conversion issue by finding that the resulting exemption claim is not effective under applicable state law. Two 1987 Oklahoma cases, In re Reid and In re Goldberg, demonstrate the willingness of bankruptcy courts to interpret the facts in such a way as to make an exemption statute inapplicable. In Reid the Bankruptcy Court determined that fifteen religious paintings valued at approximately $187,000 and received in exchange for the forgiveness of valid third party business debt owed to them were not "held primarily for personal, family and household use" as required by the exemption statute. This decision was based on (1) testimony by the debtors that they received the paintings in payment of a business debt, pledged them to secure business loans and expressed a pre-bankruptcy willingness to sell some of the paintings to pay off a business loan and (2) the separate classification of the paintings in bankruptcy schedules by the debtors as a "collection" rather than household goods. In Goldberg the Bankruptcy Court held that a gold chain and ten dollar gold piece pendent worn by the debtor were not exempt as wearing apparel under Oklahoma law since they "represent more than just ornamentation and wearing apparel. They represent an investment." Such characterizations meant that these items were not held primarily for personal nor family or household use as required by Oklahoma's exemption laws. An indication of what may be the real reasoning behind these decisions, however, is given by the following language from the Reid decision which upheld the Bankruptcy Court:

We believe that we are acting consistently with the purposes of the Oklahoma exemption statute and 11 U.S.C. Section 522(f) . . . .

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41. 757 F.2d 230 (10th Cir. 1985) (appealed from N.D. Oklahoma).
42. 59 Bankr. 201 (Bankr. N.D. Okla. 1986).
43. 757 F.2d at 232.
44. 59 Bankr. at 208. See also In re Mims, 49 Bankr. 283 (Bankr. E.D.N.C. 1985).
This case does not involve "inconsiderate creditors" depriving debtors of the necessities of life, nor was it improper for the bankruptcy court to find that the paintings were not primarily used for maintenance of debtor's home.45

Thus, the Goldberg and Reid courts balanced the claims of the creditor against how well the exemption served its underlying policy of giving the debtor a fresh start. Of necessity, this balancing focuses on the value of the property protected by the exemption claim. The real concern of the courts is whether the value of the exempt property significantly exceeds what a debtor needs to support himself and his dependents.

The Bankruptcy Code and certain states sometimes have specifically incorporated a necessity standard into exemptions. For example, section 522(d)(10)(E) of the Bankruptcy Code exempts payments under any "stock bonus, pension, profit-sharing, annuity, or similar plan . . . to the extent reasonably necessary for the support of the debtor and any dependent . . ." unless certain conditions are met.46

Several states have adopted similar limitations by restricting exemptions for debtor-created retirement plans to specific amounts or by imposing a similar "reasonable necessity" standard.47 Arkansas in certain instances has followed the same path by specifying values such as $1,200 for one motor vehicle, $750 in trade implements or a quantity such as one-half carat for wedding ring diamonds.48 Courts which apply a balancing approach, however, do not have the ability to impose a necessity or dollar standard, since their choice is only to allow or disallow the exemption. Such an "all or nothing" approach forces courts to make what may sometimes be questionable distinctions and does not allow the debtor to introduce evidence of need.

45. 757 F.2d at 236.
B. Denial of an Exemption Claim for Actual or Constructive Fraud

1. General

The per se conversion rule implies a more general rule: the conversion of nonexempt property into exempt property prior to filing bankruptcy is not always proper.49 Thus, it has been said that exemption claims are not allowed when the debtor has committed "actual or extrinsic fraud" in connection with the asset conversion.50 As used in this context, actual fraud is broader than mere misrepresentation and includes fraud such as is prohibited by fraudulent conveyance limitations—that is, actions which enable a debtor to gain an unfair advantage over creditors.51 Such fraud must be proven by clear and convincing evidence52 but may be inferred from circumstantial evidence surrounding the asset conversion transaction.53

Fraud exceptions to exemption claims raise numerous questions such as: (1) what facts constitute actual fraud; (2) what part should the debtor's motive play in finding fraud; (3) are asset conversions which involve transfers subject to challenge for constructive fraud;54 and (4) what remedies are available to creditors who successfully challenge exemption claims? These questions will be examined in detail below. However, a threshold question must first be answered: Does applicable Arkansas law or the Bankruptcy Code permit disallowance of an exemption for fraud? Many cases assume without dis-

49. See In re Reed, 700 F.2d 986 (5th Cir. 1983).

Under the Bankruptcy Act of 1898, most courts applying state exemption laws, had held property that would otherwise have been exempt to be deprived of its immunity if there was evidence other than the simple act of conversion showing that the debtor had acquired it with the intention of defrauding his creditors. Id. at 990. See, e.g., In re Miguel v. Walsh, 447 F.2d 724 (9th Cir. 1971); Shanks v. Hardin, 101 F.2d 177 (6th Cir. 1939); Kangas v. Robie, 264 F. 92 (8th Cir. 1920); In re Gerber, 186 F. 693 (9th Cir. 1911).

50. Resnick, supra note 3, at 633. "Actual fraud" as used in the context of this article is broader than fraud based on misrepresentation. See Wright v. Cies, 648 P.2d 51 (Okla. Ct. App. 1982): "Fraud is a generic term embracing every means human ingenuity can invent to enable one person to gain an unfair advantage over another . . . ." Id. at 53. See also Cooper v. Fort Smith & W.R. Co., 23 Okla. 139, 150, 99 P. 785, 789 (1909) (quoting Kerr, FRAUD AND MISTAKE 42 (1877): "All surprises, trick, cunning, dissembling, and other unfair way that is used to cheat anyone is considered as fraud.").

51. See Vanderboom v. Sexton, 460 F.2d 362, 365 (8th Cir. 1972) (actual fraud includes the successful employment of cunning, deception or artifice to circumvent, cheat or deceive (citing Mazander v. Reed, 233 Ark. 511, 514, 345 S.W.2d 469, 471 (1961))).

52. Love v. Menick, 341 F.2d 680, 682 (9th Cir. 1965).


discussion that such a fraud exception does exist. Sometimes state exemption statutes expressly incorporate fraud exceptions. For example, Oklahoma's statutory exemption for the proceeds of a life insurance policy contains an exception for "the amount of any premiums for such insurance paid in fraud of creditors . . . ."55 No similar express exceptions, however, are provided in Arkansas' constitutional homestead and other general statutory exemptions. This absence presents serious problems for creditors challenging an Arkansas exemption claim for fraud.

2. Disallowance of An Exemption for Fraud in Arkansas Bankruptcies

a. General

Whether an exemption can be defeated by a fraudulent pre-bankruptcy asset conversion is usually considered a question of state law.56 For example, the Texas case of In re Reed "interpreted Texas law to allow the exemption in full regardless of [the debtor's] intent."57 Thus, in Texas, it may not be possible to challenge an asset conversion to a homestead which involves any type of fraud.58 Arkansas' law in this area is not completely settled, since no cases expressly state such a blanket rule. Numerous Arkansas cases have considered fraudulent conveyance challenges involving exempt property. Generally, these cases have held that property exempt in the hands of the debtor prior to transfer is not subject to creditor claims. The reason is simple: The creditor "was not in a position to complain of the attempted disposition of any part of [debtor's] homestead, whether by voluntary conveyance or otherwise, since it was not subject to the payment of its claim or judgment, and, as to the homestead, there are no debts or creditors."59 Such reasoning does not apply to the transfer of nonex-

55. OKLA. STAT. tit. 36, § 3631(b) (1976).
56. In re Reed, 700 F.2d 986, 991 (5th Cir. 1983). See also cases cited supra note 34.
57. 700 F.2d at 990.
58. See also In re Theisen, 45 Bankr. 122 (Bankr. D. Minn. 1984). The court indicates doubt about whether Minnesota fraudulent conversion law can overcome Minnesota exemption law:

To sum up, I think that absent some sort of sheltering of fraudulently obtained money it is within the purview of the Minnesota exemption laws to allow the so-called conversion of non-exempt property into exempt property. Such conversion is not properly grounds for an objection to a claim of exemption made under Minnesota law.

Id. at 130-31.
59. United States Fidelity & Guar. Co. v. Smith, 103 Ark. 145, 150, 147 S.W. 54, 56 (1912). See also Bank of Salem v. White, 205 Ark. 852, 171 S.W.2d 55 (1943); Bank of Dover v. Jones, 192 Ark. 740, 95 S.W.2d 92 (1936); Middleton v. McCoy, 188 Ark. 359, 65 S.W.2d
empt assets.

One commentator stated that "non-exempt property may ordina-
roidly be exchanged for exempt property, subject again to the limitation
that there be no lien existing against the non-exempt property."60
This conclusion probably is no more than a restatement of the per se
rule, with the caveat that liens survive a transfer.61 The same com-
mentator noted three other exceptions to otherwise valid exemption
claims recognized by the Arkansas Supreme Court:62 (1) cash pro-
cceeds from the sale of exempt property, themselves exempt, may be
reached by creditors while held as money;63 (2) exempt property ac-
quired by a trustee with wrongfully appropriated trust property may
be subject to creditors;64 and (3) a wife may set aside a husband’s
fraudulent transfer of his homestead to defeat her dower.65 None of
these exceptions, however, are directly on point as to whether or not
Arkansas recognizes a general fraud exception to exemption claims.

In Littleton v. Carruthers-Jones Shoe Co.66 the debtor incurred
debt for stock purchased for his business. He then exchanged the
stock for a farm which he subsequently made his homestead. While
adopting the per se rule, the Arkansas Supreme Court discussed an
apparent fraud exception in dicta:

Now, the rule might be different if the proof was sufficient to
show that the goods were purchased from [the creditor] with the
fraudulent intent not to pay for them, for in that case the title
would never have passed on account of the fraud thus practiced,
and the creditor might in equity be permitted to trace the proceeds
of his misappropriated property into the property in which the pro-
cceeds were invested. But we have no such case here, for there is no
proof at all to the effect that [the debtor] purchased the goods with
intention not to pay for them, or that he was insolvent at the time
he purchased the goods, or that he misrepresented his financial
condition . . . [T]he only fraud, if any there be, consisted in his
disposing of the goods without leaving enough to pay his creditors.
As already shown, according to the principles settled by the deci-
sions of this court, fraud in that respect does not affect his right to

541 (1933); Barham v. Fed. Reserve Bank, 176 Ark. 1082, 5 S.W.2d 318 (1928); Sears v.
Setser, 111 Ark. 11, 162 S.W. 1083 (1914); Wilks v. Vaughan, 73 Ark. 174, 83 S.W. 913
(1904); Sannoner v. King, 49 Ark. 299, 5 S.W. 327 (1887).
61. Id. at 150 & n.17.
62. Id. at 151.
63. Id. (citing Tucker v. Stell, 169 Ark. 1, 272 S.W. 864 (1925)).
64. Id. (citing Reaves v. Coffman, 87 Ark. 60, 112 S.W. 144 (1908)).
65. Id. (citing Harrison v. Harrison, 198 Ark. 64, 127 S.W.2d 270 (1939)).
hold as exempt the property acquired by exchange.\textsuperscript{67}

But this language must be compared to the result in \textit{Ponder v. Jefferson Standard Life Ins. Co.},\textsuperscript{68} in which the creditor attempted to reach the exempt proceeds of a life insurance policy which proceeds were obtained by the alleged fraudulent conduct of the beneficiary. In denying the creditor's claim the Arkansas Supreme Court, referring to the exemption statute, held:

This language exempts all debts of whatever nature and in whatsoever manner incurred. This all-inclusive exemption may be unwise and work injustice in cases, but with that we have no concern. We repeat that this is a matter to be addressed to the judgment of the General Assembly. We deem no authority necessary for our conclusion... but such courts as have passed upon statutes exempting from process the avails of insurance policies have declined to read into them any limitation not specifically expressed therein.\textsuperscript{69}

Even if \textit{Littleton} and \textit{Ponder} can be reconciled, the \textit{Littleton} exception required that the debtor must have (1) purchased the goods with an intent not to pay or (2) misrepresented this financial condition. This is a very narrow fact pattern, although it most probably does occasionally occur. Generally, no such intent or misrepresentation exists because many times the nonexempt property transferred to obtain the exempt property has been in the debtor's possession for some period of time.

For similar reasons, equitable estoppel and waiver usually cannot be applied to asset conversion cases.\textsuperscript{70} Equitable estoppel generally requires (1) a false representation or concealment of facts, (2) made with actual or constructive knowledge, (3) to a person without knowledge concerning the truth of the representation or such facts, (4) with intent that it be acted upon, (5) and the person to whom the false representation or concealment is made acts in reliance on it, (6) to his detriment.\textsuperscript{71} Although reliance and detriment may be easily established in any particular asset conversion case, it is more difficult to

\textsuperscript{67} Id. at 496, 160 S.W. at 398.
\textsuperscript{68} 194 Ark. 829, 109 S.W.2d 946 (1937). It was alleged that the policy was obtained by a fraudulent misstatement of age by the insured and that the beneficiaries in the proof of death also fraudulently misstated the date of insured's birth.
\textsuperscript{69} Id. at 832-33, 109 S.W. at 948 (citing State v. Collins, 70 Okla. 323, 174 P. 568 (1918)); Clark v. Lunch, 31 N.Y.S. 1038 (1894)).
\textsuperscript{70} See, e.g., Sannoner v. King, 49 Ark. 299, 5 S.W. 327 (1887) (denying the use of estoppel in a fraudulent transfer of nonexempt assets).
meet the requirements that there be a false statement, knowingly made by the debtor, without contrary knowledge of the creditor.

Similarly, waiver does not seem an appropriate tool. Waiver is the voluntary or intentional relinquishment of a known right, but a waiver can be inferred from conduct.\(^7\) For example, if a debtor presented a financial statement which contained nonexempt assets it can be argued that he has waived his right to later convert such assets to nonexempt property or, equivalently, waived his right to invoke the exemption claim. The problem with this argument is that it is difficult to show that the debtor intended such a result. Given these remedial limitations, it is necessary to look for other approaches which may justify a challenge to an exemption for fraud. Statutory construction appears to offer one such avenue.

b. Statutory Construction—The Relationship Between Exemption Statutes and Fraudulent Transfer Statutes

Arkansas' legislature has expressed a strong social policy against fraud in asset conversion cases by permitting creditors to challenge transfers which defraud, hinder or delay creditors under Arkansas' Fraudulent Transfer Act.\(^7\) To allow an exemption claim acquired in a manner which is covered by these statutes is inconsistent with the legislative intent embodied in these fraudulent transfer laws.

It has been said that no statute should be interpreted wholly by its own terms.\(^7\)\(^4\) Thus, courts have sometimes considered related statutes to help interpret a statute if the enforcement of the related statute impacts on the subject matter of the statute under consideration. This is sometimes true even though the related statutes do not technically cover the same subject.\(^7\)\(^5\) Although dealing with interpretational questions involving clearly related statutes, the Arkansas Supreme Court has repeatedly stated as a rule of statutory construction that legislative acts are to be construed in such manner as to reconcile the different provisions, render them harmonious, and give intelligent effect to each.\(^7\)\(^6\) This interpretational rule should be extended to asset

\(^7\)\(^2\) For the definition of waiver see Keith v. City of Cave Springs, 233 Ark. 363, 377, 344 S.W.2d 591, 598 (1961); and, for implied waiver see Ray Dodge, Inc. v. Moore, 251 Ark. 1036, 1039, 479 S.W.2d 518, 521 (1972).

\(^7\)\(^3\) ARK. CODE ANN. §§ 4-59-201 to -213 (Supp. 1987).

\(^7\)\(^4\) Cox v. St. Anthony Bank & Trust Co., 41 Idaho 776, 242 P. 785 (1925).

\(^7\)\(^5\) Walgreen Co. v. Indus. Comm'n, 323 Ill. 194, 153 N.E. 831 (1926); Clark v. Murray, 141 Kan. 533, 41 P.2d 1042 (1935) (Statutes which are on the same subject are generally said to be "in pari materia."); Simpson County v. Burkett, 178 Miss. 44, 172 So. 329 (1937).

\(^7\)\(^6\) See In re Estate of Epperson, 284 Ark. 35, 679 S.W.2d 792 (1984), cert. denied, 471
conversion cases.

Courts should read the Arkansas exemption provisions together with Arkansas' fraudulent transfer provisions to allow creditors to invalidate asset conversions involving transfers which act to hinder, delay or defraud creditors. Courts in other jurisdictions have taken this approach.\textsuperscript{77} Even if this is a modification of early Arkansas case law, such a result is consistent with the modern view of exemption statutes. It is also consistent with the Arkansas Supreme Court’s position that "[e]very citizen of Arkansas is entitled to exemptions, mentioned in the Constitution and statutes, but in order to get his property exempt he must comply with the law."\textsuperscript{78} Debtors who voluntarily choose to ignore fraudulent transfer laws do not deserve the same level of protection as innocent debtors.

Two caveats should be noted. First, this approach will not aid creditors in situations which do not involve transfers. Second, since the homestead exemption and certain personal property exemptions are constitutional, their provisions may not be supplemented by legislative acts like those discussed.

c. Section 548 Challenges to Exemption Claims

Although some courts have treated disallowance of an exemption claim for actual or constructive fraud as purely a matter of state law,\textsuperscript{79} others have applied the fraudulent transfer provisions of section 548 of the Bankruptcy Code\textsuperscript{80} to avoid an exemption claim without reference to applicable state law.\textsuperscript{81} The bankruptcy court in\textit{In re Oliver}\textsuperscript{82} recognized a relationship between sections 522 and 548 of the Bankruptcy Code as follows:

\begin{itemize}
\item \textsuperscript{77} See, e.g., \textit{In re Levine}, 40 Bankr. 76, 79 (Bankr. S.D. Fla. 1984) ("Although the Florida Courts have recognized limited exceptions permitting a violation of the homestead protection, the exceptions are strictly construed. They are uniformly an equitable attempt to rectify otherwise heinous and unjust circumstances."); \textit{In re Olsen}, 45 Bankr. 501, 505 (Bankr. D. Minn. 1984) ("Under present Minnesota law, in order to deny a homestead exemption where a conversion occurs, it appears that a Court must find what amounts to a fraudulent conveyance . . .").\textsuperscript{infra} note 111.
\item \textsuperscript{78} Griffin v. Puryear-Meyer Grocer Co., 202 Ark. 495, 499, 151 S.W.2d 656, 658 (1941) (the creditor's claim arose because the third party did not comply with bulk sale rules).
\item \textsuperscript{82} \textit{38 Bankr. 407} (Bankr. D. Mass. 1984).
\end{itemize}
While the Court recognizes that under § 522 it is perfectly proper and indeed may be good planning for a debtor to convert non-exempt assets into those which are exempt, even on the eve of bankruptcy, the Court also recognizes that under 11 U.S.C. § 548(a) the same transfer may be avoided.\textsuperscript{83}

Thus, similar cases reason that although the existence of the exemption claim is a question of state law, the resulting claim is still subject to challenge within the framework of the Bankruptcy Code.\textsuperscript{84} This approach, however, is more restrictive to creditors because many aspects of Arkansas' fraudulent transfer rules are more liberal than those of section 548 of the Bankruptcy Code.\textsuperscript{85} For example, section 548 is subject to a one year statute of limitation while Arkansas' Fraudulent Transfer Act has limitations of up to four years.\textsuperscript{86}

As the previous discussion demonstrates, the tension between conflicting purposes has led courts to arrive at different conclusions concerning whether state exemptions statutes are subject to fraudulent transfer exceptions. One court has noted that "the right of exemption is a personal privilege. Thus, courts carefully see that the exemption laws are not construed so as to make them an instrument of fraud."\textsuperscript{87}

3. \textit{Examples of Actual or Extrinsic Fraud Which Have Resulted In a Denial of Exemption Claim}

Assuming that it is possible to challenge an exemption claim for fraud, it is next relevant to consider what actions might constitute the kind of fraud which will cause the debtor to lose his exemption. Because it is unlikely that a debtor will testify that he acted either with fraudulent intent or to delay, hinder or defraud his creditors, many times a court must imply fraud from the particular circumstances of a case.\textsuperscript{88} Certain suspicious circumstances have long been recognized by the courts as "badges" which stamp a transaction as fraudulent without actual proof of a debtor's intent. Examples include the following: dealings with a spouse, relative or other related party;\textsuperscript{89} retention of control/possession in the transferred property after the

\textsuperscript{83} \textit{Id.} at 409 (citation omitted).
\textsuperscript{84} \textit{In re Theisen}, 45 Bankr. 122 (Bankr. D. Minn. 1984).
\textsuperscript{86} ARK. CODE ANN. § 4-59-209 (Supp. 1987).
\textsuperscript{89} \textit{See, e.g.}, Rice v. Rice, 125 F. Supp. 900 (W.D. Ark. 1954); Connelly v. Thomas, 234 Ark. 1024, 356 S.W.2d 430 (1962); ARK. CODE ANN. § 4-59-204(b)(1) (Supp. 1987).
transfer, the debtor was threatened with a suit or obtained a large loan just before making the transfer; secrecy or concealment of the transferred property; insufficient consideration received by the debtor; insolvency of the debtor; deviation from normal transaction formalities; and transfer of all of the debtor's property. Generally, these factors are also useful in analyzing an asset conversion case involving a transfer.

Courts faced with the conversion of nonexempt property into exempt property on the eve of bankruptcy have relied on some of these traditional indicia of fraud as well as general principles of equity to deny exemption claims. Following are some examples of the circumstances under which exemption claims resulting from conversions have been disallowed:

1. Obtaining exempt property with funds resulting from the sale of goods purchased on credit and for which payment was not made.
2. Investing substantial assets in exempt property after inducing the creditor to withdraw an involuntary bankruptcy petition.
3. Conversion of nonexempt assets into exempt assets after a federal court order prohibiting the disposition of assets pending a further hearing.

97. See, e.g., Winner v. Hoyt, 66 Wis. 227, 28 N.W. 380 (1886); Texas Sand Co. v. Shield, 381 S.W.2d 48 (Tex. 1964).
98. See, e.g., Kangas v. Robie, 264 F. 92 (8th Cir. 1920); In re White, 221 F. Supp. 64 (N.D. Cal. 1963); Stoner v. Walsh, 24 Cal. App. 3d 938, 101 Cal. Rptr. 485 (1972); Jones v. Carpenter, 90 Fla. App. 407, 106 So. 127 (1925).
99. See, e.g., In re Gerber, 186 F. 693 (9th Cir. 1911).
4. Withdrawal of funds from business accounts for the purpose of investing in exempt property.\textsuperscript{101}

5. Conversion of nonexempt property with a value sufficient to pay all creditor claims into exempt property.\textsuperscript{102}

6. Conversion of nonexempt property to exempt property which does not provide the debtor the use of newly acquired property.\textsuperscript{103}

Just as the presence of certain facts in a case is an indication of fraud, the presence of others have been found insufficient by themselves to show fraud. For example, the per se rule already discussed states that the mere act of conversion is not in and of itself enough to prove fraud. Other circumstances which, without more, have not been determinative of fraud include:

1. The fact that a conversion creates a preference in favor of the debtor.\textsuperscript{104}

2. The value of the exempt property acquired.\textsuperscript{105}

3. The amount of time between the acquisition or conversion and bankruptcy.\textsuperscript{106}

4. The fact that the debtor converts nonexempt property into exempt property at a time when he knows he is insolvent and fully expects to become bankrupt.\textsuperscript{107}

5. Receipt of exemption advice from an attorney immediately prior to declaring bankruptcy.\textsuperscript{108}

\textsuperscript{101} In re Collins, 19 Bankr. 874 (Bankr. M.D. Fla. 1982); In re Reed, 11 Bankr. 683 (Bankr. N.D. Tex. 1981); In re Mehrer, 2 Bankr. 309 (Bankr. E.D. Wash. 1980).

\textsuperscript{102} In re Schwingle, 15 Bankr. 291 (Bankr. W.D. Wis. 1981) (Debtor had a life estate in a house which was exempt under state law. Subsequently, the debtor used nonexempt property to purchase an exempt-free interest in the same house.).


\textsuperscript{104} This conclusion is based on cases involving large conversions where the courts do not even mention amount. See, e.g., In re Adlman, 541 F.2d 999 (2d Cir. 1976) (The debtor prepaid more than $50,000 of life insurance premiums with proceeds from the sale of her house to an aunt and uncle. The court did not consider the amount at all in its conclusion). Cf In re Zouhar, 10 Bankr. 154 (Bankr. D.N.M. 1981).

\textsuperscript{105} The following cases allowed the conversion despite short time periods between conversion and bankruptcy: In re Jackson, 472 F.2d 589 (9th Cir. 1973) (“shortly before”); Love v. Menick, 341 F.2d 680 (9th Cir. 1965) (2 days); Crawford v. Sternberg, 220 F. 73 (8th Cir. 1915) (1 day); In re Ayers, 25 Bankr. 762 (Bankr. M.D. Tenn. 1982) (less than 30 days); In re Johnson, 8 Bankr. 650 (Bankr. D.S.D. 1981) (“on the eve of bankruptcy”). Contra In re Reed, 700 F.2d 986, 991 (5th Cir. 1983) (“His rapid conversion of nonexempt assets . . . speaks for itself as a transfer of property in fraud of creditors.”).

\textsuperscript{106} Wudrick v. Clements, 451 F.2d 988 (9th Cir. 1971); Schwartz v. Seldon, 153 F.2d 334 (2d Cir. 1945).

\textsuperscript{107} Wudrick v. Clements, 451 F.2d 988 (9th Cir. 1971); In re Martin, 217 F. Supp. 937
This is a difficult area to generalize since the fraud law of different jurisdictions varies widely. It is not unusual for essentially identical cases to reach opposite results.  

4. Motive in Determining Intent

Some decisions have found that the purpose for which the exempt property was acquired is an important factor in determining whether the asset conversion was a fraud on creditors. This approach has been criticized as being inconclusive since most debtors act for multiple purposes. A debtor who converts nonexempt property into an exempt homestead probably is motivated both by his desire for a new homestead and by a desire to deprive his creditors of his assets. An asset conversion case should not turn on the skillful questioning of an attorney or the artful answer of the debtor. The motive test, however, encourages just such tactics and, therefore, should not be decisive in finding actual fraud.

5. Transfers v. Pure Conversions

Some courts have permitted the use of constructive fraud under Bankruptcy Code section 548(a)(2) to invalidate a conversion. This is obviously a powerful tool which obviates the necessity of finding actual fraudulent intent. Constructive fraud under the Arkansas Fraudulent Transfer Act, however, requires a transfer which is defined to include "every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with an asset or an interest in an asset, and includes payment of money, release, lease,


110. Shanks v. Hardin, 101 F.2d 177 (6th Cir. 1939); Kangas v. Robie, 264 F. 92 (8th Cir. 1920); In re Majors, 241 F. 538 (D. Or. 1917).

111. Resnick, supra note 3, at 638. Professor Resnick observes:

In theory, it is logical to distinguish between situations that involve an intent to deprive creditors of assets and situations in which the debtor's purpose is actually to acquire the exempt property. Bankruptcy legislation and state exemptions laws were not designed to protect the debtor who acts in bad faith to deprive his creditors of assets. The debtor who obtains exempt property because he has a good faith desire to own such property is not acting with fraudulent intent and, therefore, should be permitted to keep the property free of creditors' claims.

Id.
and creation of a lien or other encumbrance." Thus, it is first necessary to distinguish between a conversion that involves a transfer or acquisition of exempt property and one which is a pure conversion of already owned nonexempt property into exempt property. *In re Olson* presents this latter situation. Immediately prior to filing bankruptcy, the debtors liquidated stock, bonds, certificates of deposit and savings accounts already owned by them and used the proceeds to make payments on the mortgages which encumbered their homestead. This fact situation should be distinguished from an actual transfer such as occurred in *In re White*. In *White* the debtor conveyed his homestead from himself to himself and his wife as tenants by the entirety, thereby taking advantage of an exemption provided by section 522(b)(2)(B) of the Bankruptcy Code. In denying the exemption, the court distinguished the transfer situation from a pure conversion as follows:

In the instant case this Court concludes that [the debtor] failed to convert his nonexempt property into exempt property. First, it is clear that this is a two party transfer in which the debtor attempted to transform his nonexempt property into exempt property by transferring an interest in that property to another person. The rule which permits conversion to nonexempt property is clearly inapplicable here. . . . In the instant case, [debtor] attempted to exempt his property by conveying part interest to his wife instead of retaining an entire interest in the property and converting it into exempt property.

Asset conversions involving an improvement and change of character emphasizes the distinction drawn by *White*. For example, in *In re Hall* the debtor was constructing an addition to his business which was to be used as a showroom. During divorce proceedings and in contemplation of bankruptcy, the debtor moved into the addition and installed drapes, electricity, carpeting and heating, but not kitchen or bathroom facilities. Subsequently, the debtor filed bankruptcy and claimed that the addition was his homestead and therefore exempt under applicable state law. Although the bankruptcy court found this to be a fraudulent asset conversion under applicable state law.

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115. Id. at 243 (emphasis added). See also *In re Porter*, 37 Bankr. 56 (Bankr. E.D. Va. 1984).
there was clearly no transfer which invoked state fraudulent transfer laws.

As used by the White court, the transfer/pure conversion distinction becomes important in determining what type of fraud, that is, actual or constructive, is sufficient to avoid an exemption under state law. Clearly, without a transfer, constructive fraud cannot be invoked. Additionally, in states like Arkansas, the lack of a transfer may mean that an exemption such as claimed in Hall is permissible.

6. The Use of Bankruptcy Code Section 548(a)(2) Constructive Fraud in Transfer Cases

Assuming that fraud can be used in Arkansas to attack a non-exempt/exempt property conversion, it becomes even more powerful as a creditor's tool if a finding of constructive fraud under Bankruptcy Code section 548(a)(2) is permitted. Difficult proof problems associated with actual fraud are avoided. For example, if a debtor is insolvent at the time of the transfer and receives nothing of value for the transfer, it has been held that: "The rule condoning property conversion from non-exempt to exempt property is inapplicable if the elements of a fraudulent conveyance are determined to exist . . . ."\(^{118}\)

The 1984 decision *In re Oliver*\(^ {119}\) presents a strong example of how this rule can be used. Ninety days before declaring bankruptcy, the debtor husband conveyed certain property owned by him and his wife as tenants in the entirety to a strawman who immediately reconveyed the same property back to the debtor and his wife so that their ownership of the property would be subject to a Massachusetts statute which would exempt that property from the claims of the debtor's creditors. On a motion for summary judgment, the *Oliver* bankruptcy court determined that the question of actual fraud was a factual question as to which summary judgment was not appropriate.\(^ {120}\) The bankruptcy court, however, granted the creditor's motion based on constructive fraud under section 548(a)(2) of the Bankruptcy Code as a matter of law since (1) the transfer took place when the debtor was insolvent and (2) the debtor received nothing for the transfer. A similar approach has been taken in other cases,\(^ {121}\) particularly those as-

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117. The bankruptcy court itself does not make the transfer distinction and indeed bases its opinion on Shanks v. Hardin, 101 F.2d 177 (6th Cir. 1939), which involved actual transfers.
120. *Id.* at 410. The court refused to find that the facts (i) of the conversion and (ii) that a family member was involved were sufficient as a matter of law to show fraudulent intent.
121. *In re Edwards*, 56 Bankr. 582 (Bankr. D. Md. 1986) (real property and automobile);
serting an exemption under section 522(b)(2)(B) of the Bankruptcy Code for property owned jointly or as a tenancy by the entirety.122 Such a technique avoids balancing the needs of the debtors and creditors and, given Arkansas' four-year statute of limitations for constructive fraud, may be particularly harsh on debtors.123

7. Remedies Available to the Creditor Who Successfully Challenges an Exemption Claim for Fraud

In many states the remedies available to a creditor who successfully challenges an exemption claim under the Bankruptcy Code resulting from a fraudulent asset conversion will take one of two forms: (1) subjecting the exempt property in question to the creditors' claims,124 or (2) bringing the nonexempt property back into the debtor's estate.125 A more interesting question is whether and to what extent creditors have an election between these remedies. This question can arise where the value of the exempt and nonexempt property vary significantly after the asset conversion, encouraging creditors to try to reach the more valuable of the two. The trustee in In re Schwingle126 tried this approach when the debtor converted a nonexempt promissory note payable to her into an exempt homestead. Believing the exempt homestead to be more valuable, the trustee argued that the appropriate remedy was to deny the exemption claim, thus making the homestead available to creditors rather than bring the promissory note back into the estate. The trustee made this argument under section 67(d) of the Bankruptcy Act which provided that the bankruptcy court could preserve the transfer for the benefit of the estate. Balancing the conflicting interest between the debtor and the creditor, the bankruptcy court refused to take such action. The Bankruptcy Code removed this provision. However, this argument may still be available to a creditor under Arkansas law. Section 4-59-207(a)(3) of the Arkansas Fraudulent Transfer Act states that a court may "[s]ubject

In re Porter, 37 Bankr. 56 (Bankr. E.D. Va. 1984) (real property transferred from debtor to debtor and wife as joint tenants); In re White, 28 Bankr. 240 (Bankr. E.D. Va. 1983) (real property transferred by debtor to debtor and wife as joint tenants).

122. 11 U.S.C. § 522(b)(2)(B) (1982 & Supp. IV 1986) exempts "any interest in property in which the debtor had, immediately before the commencement of the case, an interest as a tenant by the entirety or joint tenant to the extent that such interest as a tenant by the entirety or joint tenant is exempt from process under applicable nonbankruptcy law."

123. ARK. CODE ANN. §§ 4-59-207(a), (b) (Supp. 1987).


to applicable principles of equity” grant the creditor “[a]ny other relief the circumstances may require.” This provision seems to open the door to the same equitable arguments proposed by the trustee in Schwingle as an alternate equitable remedy.

C. Denial of Discharge

Denial of discharge is a third way to prevent debtors from abusing their right to convert nonexempt property to exempt property on the eve of bankruptcy. To the extent Arkansas bankruptcy courts disallow a fraud exception to exemption claims, it may be the only way for creditors to challenge an asset conversion. Such a sanction is disastrous to the debtor, since it nullifies the primary bankruptcy purpose of relieving the debtor from his indebtedness and providing him with a fresh start. Cases in this area have generally focused on two exceptions to discharge under sections 727(a)(2) (fraudulent conveyance) and 727(a)(4) (fraudulent oaths or claims) of the Bankruptcy Code.

Bankruptcy Rule 4004 provides that in a Chapter 7 case a creditor or trustee objecting to discharge must file a complaint “not later than 60 days following the first date set for the meeting of creditors held pursuant to Section 341(a).” An objection to discharge is an adversary proceeding governed by Part VII of the Bankruptcy Rules. Unless an extension of time has been granted, an objection to discharge untimely filed is fatally flawed. As with a challenge to an exemption claim, the burden of proving the objection is on the party making the objection. This changes prior bankruptcy law which shifted the burden of proof to the debtor after the objecting party made out a prima facie case. The burden of going forward, however, may be shifted to the debtor once the objecting party shows facts demonstrating that the debtor has taken any of the actions prohibited by section 727(a) of the Bankruptcy Code. A preponderance of the

128. Bankr. R. 4004(a). For a Chapter 11 case a complaint must be filed not later than on the first date set for a hearing on confirmation.
131. In re Decker, 595 F.2d 185 (3d Cir. 1979); Bankr. R. 407.
evidence is the degree of proof required.\textsuperscript{133}

The 1987 case of \textit{In re Swift} \textsuperscript{134} presented claims under these two areas to the United States Bankruptcy Court for the Western District of Oklahoma. The bank creditor alleged that (1) a $17,906 pre-bankruptcy payment on a promissory note secured by a second mortgage on the debtors' homestead was a fraudulent transfer sufficient for the court to deny discharge under section 727(a)(2) of the Bankruptcy Code and (2) a $750 transfer to a son's trust made five months before bankruptcy and not disclosed in the bankruptcy schedules was cause for the court to deny discharge under section 727(a)(4) of the Bankruptcy Code. Notwithstanding these allegations the Bankruptcy Court denied the creditor's objection to discharge. Since the facts of \textit{Swift} are not particularly unusual in asset conversion cases, the operation of these two provisions should be examined in detail.

\textbf{1. Transfers with Intent to Hinder, Delay, or Defraud Under Section 727(a)(2)}

Unlike cases dealing with denial of exemption claims, a debtor's entitlement to a discharge is determined by federal law.\textsuperscript{135} Since section 727(a)(2) is derived directly from section 14(c) of the Bankruptcy Act, there is ample interpretive federal case law. This case law suggests that the scope of section 727(a)(2) is narrower than challenges to exemption claims. First, by its own terms, section 727(a)(2) only applies to prohibited transactions within one year before the date of filing the petition. An objection to exemption under state law may be based on significantly older transactions. Second, there must be actual fraudulent intent, as distinguished from constructive intent (or constructive fraud), which may be invoked under section 548(a)(2) of the Bankruptcy Code or equivalent provisions of state law. Third, some courts have noted that "[a] higher degree of fraud is required to deny a discharge than to deny a claimed exemption."\textsuperscript{136} Finally, as previously discussed, the burden of proof (persuasion) always remains on the objecting party.

Like Arkansas law, actual fraudulent intent under section

\begin{itemize}
\item \textsuperscript{134} 72 Bankr. 563 (Bankr. W.D. Okla. 1987).
\item \textsuperscript{135} \textit{In re Reed}, 700 F.2d 986, 991 (5th Cir. 1983).
\item \textsuperscript{136} \textit{In re Adlman}, 541 F.2d 999, 1006 n.11 (2d Cir. 1976); \textit{In re Ostrer}, 393 F.2d 646 (2d Cir. 1968).
\end{itemize}
727(a)(2) may be inferred from circumstantial evidence. Once again, however, the per se conversion rule requires the demonstration of facts other than the mere conversion to find fraud. In proving actual fraud, federal law, like state law, also recognizes certain traditional badges of fraud such as (1) retention of use of transferred property, (2) transfers to family members and (3) lack of consideration for the transfer.

2. False Oaths and Claims

Many times a creditor attacking discharge under section 727(a)(2) also asserts that discharge should be denied because of a false oath under section 727(a)(4) of the Bankruptcy Code. Application of this section is demonstrated in In re Collins and In re Ellingson. Both involved prebankruptcy asset conversions which were not initially disclosed in the bankruptcy schedules, even though the debtors declared "under penalty of perjury" that they had read the Schedules and that the Schedules or Statement of Financial Affairs (as applicable) were "true and correct" to the "best of" the debtors' "knowledge, information and belief." In both cases, failure to adequately disclose the asset conversion transactions resulted in a creditor assertion that the debtors' made a "false oath or account" within the meaning of section 727(a)(4).

Generally, a court may deny a debtor a discharge under section 727(a)(4) only for a false oath or account made in connection with a bankruptcy proceeding. Additionally, a false statement not made under oath should not deprive the debtor of discharge. False oaths can arise in any of several circumstances. First, both the bankruptcy schedules and the Statement of Financial Affairs require the debtor
to make certain disclosures which should reveal asset conversions. Second, the false statement could occur during trial, or, more likely, at the first section 341(a) meeting of creditors.

In these cases, the burden of proof (persuasion) is again on the creditor to show that the debtor violated section 727(a)(4). The term "knowingly and fraudulently" requires that there be "an intentional untruth in a matter material to the bankruptcy." This definition means that a court will not deny a discharge if the false statement or omission is a mistake or is immaterial. From the creditor's standpoint it is not necessary to show a bad motive or prejudice to the creditor. On the other hand, errors and omissions which amount to a reckless indifference to the truth, may be sufficient to show that the debtor made the false statement "knowingly and fraudulently." Based on these section 727(a)(4) general rules, debtors and their counsel should note two caveats often invoked in section 727(a)(4) litigation, one by debtors and the second by creditors.

The first usually helps debtors. Generally, a debtor who acts in reliance on the advice of his attorney in completing the schedules lacks the required intent to meet the requirements of section 727(a)(4). Since attorneys are many times involved in the process of preparing bankruptcy filings this exception recognizes and takes into account the information transfer problems which can confront the debtor and his counsel. The debtors in both Collins and Ellingson raised this exception to protect them.

147. In re Adisman, 541 F.2d 999 (2d Cir. 1976).
151. In re Marshall, 47 F.2d 209 (2d Cir. 1931).
154. In re Mascolo, 505 F.2d 274 (1st Cir. 1974); In re Topper, 229 F.2d 691 (3d Cir. 1956); In re Norman, 41 Bankr. 13 (Bankr. M.D. Ala. 1984).
In both cases attorneys helped the debtors fill out the schedules. The trustee in *Collins* discovered a prebankruptcy satisfaction of mortgage from an inspection of public real estate records prior to the section 341(a) hearing. At that hearing the debtor freely admitted the pay-off, and the schedules were subsequently amended to cure the defect.\(^{155}\) In *Ellingson* questions asked at the section 341 hearing made it clear to the debtor's attorney that the schedules contained incorrect information. As a result, but subsequent to the hearing, the debtors' attorney called the trustee to advise him of the errors and to explain what in fact happened. In addition, the debtor's attorney also amended the schedules to fully disclose the conversions.\(^{156}\) There are only two distinctions between these two cases. First, the *Collins* trustee was able to independently discover the asset conversion from public records, while this option was unavailable to the *Ellingson* trustee since the transaction in question did not result in any public filing. Second, the debtor and his attorney in *Ellingson* testified that the debtor "was extremely concerned about ... apparent discrepancies in the bankruptcy schedules" and called his attorney frequently "to inquire about the schedules and to make certain they were correct."\(^{157}\) Based on these facts, the *Collins* debtor was unsuccessful because of the caveat to the attorney advice rule: The debtor's reliance must be reasonable.\(^{158}\) The court in *Collins* found that the only reason for the omission, that is the failure to disclose the conversion transaction, was "to prevent the trustee from protecting the estate. To list is to alert, to omit is to buy quiescence, i.e., don't wake up a sleeping dog. The Court simply does not believe the debtor when he suggests that the omission was innocent."\(^{159}\) *Ellingson* distinguishes *Collins* as follows:

*Collins* holds that the reliance upon the attorney was not a good faith reliance under the facts of that case. In *Collins*, the trustee had to ferret out the existence of a transfer from official public records and confront the debtor with that information before the debtor would admit that the schedules were in error.\(^{160}\)

The debtors' due diligence in making frequent inquiries and the attorney's due diligence in making a disclosure and amendments following

\(^{155}\) 19 Bankr. 874, 878 (Bankr. M.D. Fla. 1982).
\(^{156}\) 63 Bankr. 271 (Bankr. N.D. Iowa 1986).
\(^{157}\) *Id.* at 276.
\(^{158}\) *In re* Bateman, 646 F.2d 1220, 1224 (8th Cir. 1981); *In re* Ailetcher, 49 Bankr. 681 (Bankr. D. Haw. 1985).
\(^{159}\) 19 Bankr. 874, 878 (Bankr. M.D. Fla. 1982).
\(^{160}\) 63 Bankr. 271, 277 (Bankr. N.D. Iowa 1986).
the section 341 hearing combined to avoid the adverse impact of section 727(a)(4) in Ellingson.

The second caveat favors creditors. Generally, amendments made after the false oath will not cure the problem. Absent reasonable reliance on counsel, mistake or immateriality, a false statement once made cannot be cured by amendment. The egg once broken, cannot be put back together.

IV. ASSET CONVERSIONS AND THE MODEL RULES OF PROFESSIONAL CONDUCT

As demonstrated by the cases already discussed in this article, a debtor's asset conversion many times begins with his attorney. After determining that a debtor has serious creditor problems, the typical conversation may proceed along these lines:

**Debtor's Question:** "If someone takes a judgment against me or if I go into bankruptcy, what property can I keep?"

**Attorney's Answer:** "In Arkansas, property such as the house in which you live, in other words your homestead, and certain other classes of personal property are exempt from the claims of your creditors."

**Debtor's Question:** "You know my financial condition, how can I protect as many of my assets as possible from my creditors?"

This dialog raises potentially difficult ethical problems for attorneys, as is amply demonstrated by the 1981 Wisconsin case of In re Schwingle. In May, 1977, Mrs. Schwingle, a seventy-nine year old widow, was faced with a $112,000 personal judgment against her. At that time, she lived on a farm which she had sold to her two sons in 1974, reserving a life estate for herself in a house located on the farm. The sons paid for the farm by giving her their promissory note for $31,730.78 secured by a mortgage on the farm. After the court entered judgment, Mrs. Schwingle was clearly insolvent with no way to

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pay the judgment creditor. She immediately contacted her attorney "because of her concern that the (judgment creditor) would levy on her assets." As a result of that conference, the attorney wrote Mrs. Schwingle a letter proposing two possible alternatives: (1) her sons could pay off their 1974 note to her and she could use the proceeds to purchase a homestead; or (2) her sons could resell the home to her in satisfaction of her 1974 note and mortgage. Either action would result in the conversion of a nonexempt asset (the note and mortgage) into an exempt asset (the homestead). Subsequently, the attorney delivered a second letter confirming his prior written recommendations but containing the following warning:

I've also previously advised you that taking that action (the conversion of nonexempt property to exempt property) will most likely cause you to be involved in a legal action by the (judgment creditor) in an effort to upset your repurchase of the homestead. It is my opinion . . . that such an action on your part is perfectly proper. Obviously, only the judge will tell us if in fact it was proper . . . .

Based on the attorney's advice, the sons reconveyed to Mrs. Schwingle a portion of the farm, including her homestead, in consideration for a $25,000 reduction in their debt to her. At the same time, Mrs. Schwingle executed a will leaving that reconveyed portion of the farm to her sons. Less than two months later, Mrs. Schwingle declared bankruptcy.

On these facts the trial court found the asset conversion was made with actual intent to defraud creditors within the meaning of section 67(d) of the Bankruptcy Act. Thus, the court's decision justified the attorney's warning. Many of the cases already discussed or cited in this article involve facts similar to those of In re Schwingle and present the same practitioner problems. For Arkansas practi-

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164. *Id.* at 292.
165. *Id.* at 292-93. This advice was confirmed in a letter dated June 8, 1977 from the attorney to Mrs. Schwingle, in which he states:

As you know the plaintiff will be asking for and will receive judgment against you on the basis of the verdict on June 13, 1977. I have advised you that prior to that date we will take the nonexempt asset you have (the mortgage note and mortgage) and use that as consideration for you to purchase an exempt asset (your house made a homestead).

*Id.* at 293.
166. *Id.* at 295. This case was brought by the trustee and judgment first rendered by the bankruptcy court prior to October 1, 1979, the effective date of the Bankruptcy Code, and was therefore decided under prior law.
167. *Id.* at 292.
168. *In re* Saunders, 37 Bankr. 766 (Bankr. N.D. Ohio 1984); *In re* Hall, 31 Bankr. 42
tioners, these problems must be solved by reference to the Model Rules of Professional Conduct (Model Rules) as adopted by Arkansas.  

A fundamental principle of a lawyer's professional responsibility is that everyone should have access to the services of a competent attorney. On the other hand Model Rule 1.2(d) states that "a lawyer shall not counsel a client to engage, or assist a client in conduct that the lawyer knows is criminal or fraudulent . . . ." As previously discussed, this issue may arise because Arkansas law may make some asset conversions fraudulent as to creditors. In the hypothetical debtor/attorney conversation discussed previously, does an attorney who tells a debtor "how" to protect his assets violate the Model Rules?

To answer this inquiry it is necessary to first recognize that the "how to" question involves a two-part analysis which is common to most client questions. The first part is "tell me (the client) what the law is," while the second part is "advise me (the client) how to take advantage of that law given my factual circumstances." How far can attorneys go in answering? Case law and Bar Association advisory opinions from sister states supply some guidance.

In 1984 the South Carolina Bar Ethics Advisory Committee issued an opinion which addressed a related issue under the Code of Professional Responsibility:

Can an attorney participate in a transfer of a client's property from the client's name to his spouse's name in anticipation of the possibility of the judgment being entered against the client where the

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169. Effective January 1, 1986, the Code of Professional Responsibility was superseded in Arkansas by a version of the Model Rules of Professional Conduct promulgated by the American Bar Association. All references in this article to the "Model Rules" shall refer to the Model Rules of Professional Conduct as adopted by the Arkansas Supreme Court. In the matter of the Arkansas Bar Association: Petition for the Adoption of Model Rules of Professional Conduct, 287 Ark. 495, 702 S.W.2d 326 (1985).

170. See Ark. Mod. R. Prof. Conduct 1.1 ("A lawyer shall provide competent representation to a client").

171. Ark. Mod. R. Prof. Conduct 1.2(d). See also Ark. Mod. R. Prof. Conduct 8.4(a) (professional misconduct to violate the Model Rules), 8.4(c) (professional misconduct to be involved in fraud, deceit or misrepresentation) and 8.4(d) (professional misconduct to be involved in conduct which is prejudicial to the administration of justice).

172. See In re Alschuler, 388 Ill. 492, 58 N.E.2d 563 (1945) (disciplinary action for anything calculated to deceive); Hicks v. State, 422 S.W.2d 539, 541 (Tex. Civ. App. 1967) ("'Fraudulent conduct' means an act, omission, or concealment done, made or affected as an attorney with a purpose, design or intent to carry out fraud or wrong").
sole purpose of the transfer would be to avoid the possibility that a creditor would recover a deficiency judgment against the property conveyed? 173

The Committee concluded that such conduct was permissible so long as there is no "immediate" reasonable prospect of a judgment being entered against the client. A transfer merely to avoid the future possibility of a creditor suit is not a violation of the disciplinary rules. 174 This opinion seems to support the role of the attorney in creating a plan to avoid "potential" creditor problems. But what happens if the contemplated transfer is more "immediate?" This author has not found any Arkansas case law directly on point. However, other states have considered the question.

In Townsend v. State Bar of California 175 the court suspended an attorney from practice because he advised his client to transfer property for the purpose of defrauding a judgment creditor. The client made the transfer two days before the judgment was taken. Based upon a somewhat analogous fact situation, a Massachusetts attorney was suspended for four months for helping a client conceal assets from a potential creditor by the creation and foreclosure of false mortgages. 176 In a similar vein the Texas Bar Committee on the Interpretation of the Canons issued an opinion which states that an attorney may not participate in a fraudulent conveyance of a homestead to a third party. 177 These cases clearly indicate that attorneys are not protected by their status as advisors and advocates and can step over the line of propriety in asset conversion cases.

Although not directly on point, the Model Rules provide guidance for practitioners. Model Rule 1.3 requires that a "lawyer . . . act with reasonable diligence and promptness in representing a client" while Model Rule 1.1 mandates "competent representation." 178 Clarifying these obligations, Model Rule 1.2 provides:

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174. See Arkansas Code of Professional Responsibility, DR 7-102(A)(7) (replaced 1986) and ARK. MOD. R. PROF. CONDUCT 1.2(d) and the Code Comparison.
175. 32 Cal. 2d 592, 197 P.2d 326 (1948).
177. Opinion of the State Bar of Texas Committee on Interpretation of the Canons Ethics Op. No. V-39 (May 1951) (the third party would reconvey retaining an artificial vendor's lien or execute a mortgage and reconvey back to the owner who assumes the mortgage) (text of opinion is contained in 18 BAYLOR L. REV. 212-13 (1966)).
178. ARK. MOD. R. PROF. CONDUCT 1.1 states that "competent representation requires the legal knowledge, skill, thoroughness and preparation reasonably necessary for representation."
(a) A lawyer shall abide by a client's decisions concerning the objectives of representation, subject to paragraphs . . . , (d) . . . , and shall consult with the client as to the means by which they are to be pursued . . .

(d) A lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent, but a lawyer may discuss the legal consequences of any proposed course of conduct with a client and may counsel or assist a client to make a good faith effort to determine the validity, scope, meaning or application of the law.179

Model Rule 1.4 goes even further by requiring a lawyer "to explain a matter to the extent reasonably necessary to permit the client to make informed decisions regarding the representation."180 Thus, it appears clear that an attorney whose client asks the "how to" question with respect to asset conversions must first advise the debtor as to how Arkansas law might treat asset conversions. This information includes at least the following: (1) the existence and scope of Arkansas' exemptions; (2) the per se rule; (3) Arkansas' law providing that transfers made with actual or constructive intent to defraud are fraudulent as to creditors; (4) if applicable, the possible avoidance affects of sections 544 and 548 of the Bankruptcy Code; and (5) the risks, to the debtor of loss of exemption, reversal of transfer and/or loss of discharge in bankruptcy if a court subsequently finds that the exemption conversion was fraudulent.

The attorney's letters in Schwingle generally discussed these issues, but the first letter went further and actually suggested alternative methods using specific assets of the debtor with recommendations as to how to implement the asset conversion. In hindsight and based on the court's ruling, however, the attorney advised and helped implement a plan which was found to constitute fraud on Mrs. Schwingle's creditors. This result raises the more difficult question as to what extent an attorney should be involved in implementing an asset conversion once he has advised a client as to the legal boundaries.

The Comments to Model Rule 1.2 suggests that there are limits to the lawyer's role.

When the client's course of action has already begun and is continuing, the lawyer's responsibility is especially delicate. The lawyer is not permitted to reveal the client's wrongdoing, except where permitted by Rule 1.6. However, the lawyer is required to avoid

179. Id. 1.2 (emphasis added).
180. See also Id. 3.1 (Meritorious Claims and Contentions).
furthering the purpose, for example, by suggesting how it might be concealed. A lawyer may not continue assisting a client in conduct that the lawyer originally supposes is legally proper but then discovers is criminal or fraudulent. Withdrawal from the representation, therefore, may be required . . . Paragraph (d) applies whether or not the defrauded party is a party to the transaction. Hence, a lawyer should not participate in a sham transaction; for example, a transaction to effectuate criminal or fraudulent escape of tax liability.\textsuperscript{181}

The key to complying with Model Rule 1.2 is whether the lawyer knows the conduct is fraudulent. The Model Rule states that "'knows' denotes actual knowledge of the fact in question"\textsuperscript{182} while the term "'fraudulent' denotes conduct having a purpose to deceive and not merely negligent misrepresentation or failure to apprise another of relevant information."\textsuperscript{183} Thus, the lawyer's role is based on his knowledge of the client's purpose or intent behind an asset conversion transaction.\textsuperscript{184} As indicated in the section of this article dealing with the role of motive in finding actual fraud, it is the rare debtor who does not have two or more motives for an asset conversion. If a debtor has two motives, the attorney may resolve reasonable doubts in favor of his client. Such a resolution, however, may depend in part on skillful questioning of the debtor by the attorney to establish multiple motives. This must obviously be done in good faith for the attorney to determine that his doubt is reasonable. Nor should the attorney assist in creating the motive. Additionally, reliance on a "desire to own the exempt property" as one of the motives should concern the attorney because recent case law suggests that reason is inadequate

\textsuperscript{181} Id. 1.2 comment (emphasis added).
\textsuperscript{182} Id. terminology. The definition goes on to state that "'[a] person's knowledge may be inferred from circumstances."
\textsuperscript{183} Id.
\textsuperscript{184} Id. 1.2 code comparison generally cross references to DR 7-101(A) of the Code of Professional Responsibility. Although not specifically referenced in the Code Comparison to the Model Rules ethical consideration 7-6 supports this conclusion:

Whether the proposed action of a lawyer is within the bounds of the law may be a perplexing question when his client is contemplating a course of conduct having legal consequences that vary according to the client's intent, motive, or desires at the time of the action. Often a lawyer is asked to assist his client in developing evidence relevant to the state of mind of the client at a particular time. He may properly assist his client in the development and preservation of evidence of existing motive, intent, or desire; obviously, he may not do anything furthering the creation or preservation of false evidence. In many cases a lawyer may not be certain as to the state of mind of his client, and in those situations he should resolve reasonable doubts in favor of his client.

\textit{Model Code of Professional Responsibility, EC 7-6.}
This conclusion is also consistent with a "good faith" exception which some jurisdictions have adopted. For example, in *State v. Baker*, the Texas Court of Civil Appeals held that an honest, good faith belief that services are well founded and in the best interest of a client is a defense to a malpractice or disbarment action.

Finally, this discussion does not purport to consider all of the ethical questions which can be raised by an exemption conversion. For example, attorneys should consider the impact of Model Rules 3.7 and 1.16(a)(1) which require withdrawal as counsel under some circumstances when a lawyer becomes a witness, Model Rules 1.2(a) and 1.6 concerning preservation of confidences and secrets of a client and Model Rule 1.7(b) involving conflicts of interest in representing multiple clients (such as a husband and wife). At a minimum, however, lawyers must not only advise debtors about potentially serious adverse affects to the debtors of asset conversions, but must also understand the ethical questions raised in such situations.

V. ACTIONS FOR DAMAGES AGAINST ATTORNEYS

The previous discussion focuses on ethical problems presented by asset conversions. But, lawyers who counsel or engage in fraudulent conduct may also have civil liabilities to creditors. For example, in

185. See supra note 18 for cases disallowing asset conversions. In *In re Martin*, 217 F. Supp. 937 (D. Oregon 1963) the debtor conferred with his attorney one day before bankruptcy about how to conserve $400 cash which he had just received from the sale of some real property. The debtor testified that the attorney "told me I was allowed the rifle and pistol and a whole bunch of exempt articles." *Id.* Based on this advice the debtor decided the $400 "was to go . . . hundred and seventy-five for the bankruptcy, which was . . . I had to do, twenty-five dollars legal fee for the sale of the house and two hundred dollars for the rifle." *Id.* Based on this quite honest testimony, the bankruptcy referee found that the debtor's conversion was "effected with a conscious effort to convert non-exempt assets into exempt assets with the purpose of making them unavailable . . . in a contemplated bankruptcy proceedings . . . ." *Id.* at 938.

186. 539 S.W.2d 367 (Tex. Civ. App. 1976). See also People *ex rel.* Chicago State Bar Ass'n v. Lotterman, 353 Ill. 399, 187 N.E. 424 (1933) (acts done in good faith and without conscious and willful perpetration of wrong do not require disbarment even though contrary to professional ethics).

187. In other words whether answering the question of "how to" makes the lawyer a witness as to the intent of the debtor in making an exemption conversion.

188. For example, suppose the client gives subsequent information which causes the lawyer to doubt the motive.

McElhanon v. Hing\textsuperscript{190} an attorney was held liable for $286,120 in damages for involvement in a scheme to defraud a judgment creditor. The attorney participated in negotiating and drafting a stock transfer transaction knowing that his client was or would be rendered insolvent by the transfer. Affirming the trial court, the Arizona Supreme Court held that conduct which hindered, delayed or defrauded the creditor was actionable.\textsuperscript{191} In an era of expanding lender liability theories, debtor attorneys involved with asset conversions should themselves be wary of creditors searching for remedies and deep pockets.

**VI. Conclusion and Recommendations**

The justifications for the per se conversion rule, the bankruptcy policy of affording a debtor a fresh start, and the goals of exemption laws are all consistent with permitting a debtor to acquire, improve or otherwise convert nonexempt property into exempt property in contemplation of bankruptcy. As seen from the cases discussed in this article, the real difficulty faced by the courts in asset conversion cases is balancing these justifications and goals against the right of creditors to be treated fairly in the distribution of the debtor's estate. As a result of this concern, courts have resorted to judicial techniques to avoid results which are unfair to creditors. These techniques include (1) interpreting the facts to find that the resulting exemption claim actually does not fit the statutory exemption, (2) disallowing the exemption because of constructive or actual fraud, and (3) denying discharge for actual fraud. Applying these techniques, courts have arrived at widely varying results, even in similar fact situations. The variety of state laws is one reason. But when these various situations are examined, it appears that the courts usually have one common concern. Although some courts have denied that the value of the resulting exempt property is determinative, others have more openly stated that judicial approval of the conversion of nonexempt property to exempt property without regard to the value of that property is unfair to creditors. The resulting case law has been confusing, because no valuation standard is provided in most state exemptions.

As a result Arkansas lawyers are severely handicapped in properly advising their clients for at least three reasons: (1) lack of uniformity in court decisions which purport to apply similar principles but reach differing results; (2) the open question of whether and to


\textsuperscript{191} 151 Ariz. at 407, 728 P.2d at 277 (1986).
what extent a creditor can attack an Arkansas exemption claim for
fraud; and (3) the disastrous consequences to the debtor if a court, on
hindsight, determines that the asset conversion worked as a fraud on
creditors. In these situations, attorneys are forced to walk a tightrope
between their ethical obligations to the court and their client. To as-
sist practitioners in dealing with these issues, the Arkansas legislature
should consider two alternative statutory remedies:

First: Arkansas should consider adopting a statutory presump-
tion that asset conversions within a certain time period of bankruptcy
are presumed to be made in contemplation of bankruptcy and are
either (1) avoidable or (2) subject to creditor claims, unless the debtor
can prove that the asset conversion was made for reasons other than
contemplation of bankruptcy. Illinois has adopted such an exception
which provides: “Property acquired within six months of the filing of
the petition for bankruptcy shall be presumed to have been acquired
in contemplation of bankruptcy.”\(^{192}\) Rather than use the term “ac-
quired” it might be less ambiguous to reword the statute to cover all
asset conversion mechanisms.

For example:

The acquisition, improvement or other conversion of nonexempt
property to exempt property within six months of the filing of a
petition for bankruptcy shall be presumed to have been acquired,
improved or otherwise converted in contemplation of bankruptcy.

Such a statutory approach places the burden on a debtor to justify his
actions in terms of the goals and purposes of both exemption statutes
and the Bankruptcy Code.

Second: To avoid the current uncertainties in the law, Arkansas’
exemption statutes (to the extent permitted by the constitution)
should expressly be made subject to actual and constructive fraud ex-
ceptions. This action will (1) make sure that debtors and creditors
know the rules and (2) provide a mechanism for creditors to attack
asset conversions other than by objecting to discharge.

Acting on these two proposals will clarify Arkansas’ position on
pre-bankruptcy asset conversions and allow courts to balance the
needs of debtors with the rights of creditors in a manner consistent
with the twin purposes of the Bankruptcy Code.