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# “NO HARM, STILL FOUL”: UNHARMED CREDITORS AND AVOIDANCE OF A DEBTOR’S PRE-PETITION TRANSFER OF EXEMPTIBLE PROPERTY

ALYSSA POMPEI<sup>†</sup>

## INTRODUCTION

Mr. and Mrs. Smith are Florida residents who have owned their home for two years. Both of them have been trying hard to make ends meet, but bills have been mounting since Mr. Smith got laid off and their daughter needed physical therapy not covered by insurance. Sick of having to take the phone off the hook to avoid the debt collectors’ incessant calls, Mr. Smith decides that it might be time to file for bankruptcy. He performs a quick Google search on Florida bankruptcy law and realizes that under the Florida Constitution, the homestead is exempt from a forced sale if it is owned by a “natural person.”<sup>1</sup> Still feeling uneasy because the bills and deed to the home are in his name, he decides to transfer the property to his wife to make sure it is safe from creditors. He reasons that if the house would be exempt from a forced sale after he files for bankruptcy there is no harm in transferring it early to avoid premature claims by overeager creditors. Anxious about the prospect of creditors trying to take his home, he has his lawyer draw up a deed transferring the home to his wife for twenty dollars in consideration. Six months later, he files for bankruptcy. Immediately after his first court appearance, the court-appointed

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<sup>1</sup> FLA. CONST. art. X, § 4(a) (“There shall be exempt from forced sale . . . the following property owned by a natural person: (1) a homestead . . .”).

trustee overseeing the estate files suit against Mrs. Smith to recover the property her husband transferred to her alleging it was fraudulently transferred. What result to Mr. Smith?

The plain language of the Florida statute seems straightforward: The trustee would not be able to avoid Mr. Smith's transfer of his homestead which occurred prior to his petition for bankruptcy because the property is exempt under Florida state law.<sup>2</sup> The United States Bankruptcy Court for the Southern District of Florida decided accordingly, analyzing these types of transfers under a "no harm, no foul" approach.<sup>3</sup> Under this reasoning, if the creditor is not harmed by the pre-petition transfer of property otherwise exempt from the bankruptcy estate under state law, the pre-petition transfer cannot be avoided.<sup>4</sup> However, the Bankruptcy Court for the Southern District of Florida is in the minority regarding decisions on this issue.<sup>5</sup> The majority of federal courts have held that under § 548 of the Bankruptcy Code ("Code"),<sup>6</sup> a trustee can avoid a debtor's pre-petition transfer of property, regardless of whether the property would have been otherwise exempt under applicable state laws, because such a transfer constitutes a "fraudulent conveyance."<sup>7</sup> This reasoning stems from the notion that all property is part of the bankruptcy estate until the debtor claims an exemption.<sup>8</sup> Thus, allowing pre-petition transfers could harm creditors because it is never definite that a debtor will claim an available exemption.<sup>9</sup>

The core principles of federal bankruptcy law, codified in the Bankruptcy Code, are twofold: (1) to ensure maximum and equitable distribution of the debtor's assets among creditors and (2) to give the debtor a fresh start.<sup>10</sup> The fraudulent conveyance<sup>11</sup>

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<sup>2</sup> *Id.*

<sup>3</sup> See *Kapila v. Fornabaio (In re Fornabaio)*, 187 B.R. 780, 782–83 (Bankr. S.D. Fla. 1995); see also *Malone v. Short (In re Short)*, 188 B.R. 857, 860 (Bankr. M.D. Fla. 1995).

<sup>4</sup> *In re Fornabaio*, 187 B.R. at 782.

<sup>5</sup> See *Tavener v. Smoot*, 257 F.3d 401, 406 (4th Cir. 2001) (stating that a majority of courts have rejected the "no harm, no foul" approach).

<sup>6</sup> 11 U.S.C. § 548 (2012).

<sup>7</sup> See, e.g., *Tavener*, 257 F.3d at 407–08; *Lasich v. Wickstrom (In re Wickstrom)*, 113 B.R. 339, 351, 352 (Bankr. W.D. Mich. 1990).

<sup>8</sup> *Tavener*, 257 F.3d at 407.

<sup>9</sup> See, e.g., *id.*

<sup>10</sup> *BFP v. Resolution Trust Corp.*, 511 U.S. 531, 563 (1994) (Souter, J., dissenting) (citing *Stellwagen v. Clum*, 245 U.S. 605, 617 (1918)).

and preferential treatment<sup>12</sup> provisions of the Code help achieve the first goal by protecting creditors' claims to the bankruptcy estate. The Code furthers the fresh start goal by allowing the debtor to protect certain assets from creditors by exempting them from the bankruptcy estate.<sup>13</sup> However, the interests of the creditor and debtor conflict when determining whether a debtor should be permitted to transfer otherwise exempt property prior to his petition for bankruptcy. On one hand, courts could protect the rights of the creditor by deeming all pre-petition transfers of assets "fraudulent" regardless of their status as exempt under state law. Alternatively, courts could aim to protect the debtor's right to a fresh start by determining that unless a creditor's financial interests are harmed, the transfer cannot constitute a "fraudulent conveyance" if the assets would be exempt under state law.

This Note sides with the "no harm, no foul" approach in this debate, arguing that bankruptcy courts should not avoid pre-petition transfers of otherwise exempt property under § 548 simply because an exemption was not actually taken and the transfer was instead the alternative path used to shield the property from collection. Part I of this Note explains the constructive fraud and exemption provisions of the Bankruptcy Code, including state opt-out provisions which are particularly applicable to this issue. Part I also discusses the legislative history of federal bankruptcy law with particular focus on the creation of the Bankruptcy Code in 1978, which altered the definition of the bankruptcy estate.<sup>14</sup>

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<sup>11</sup> 11 U.S.C. § 548(a)(1) (allowing a trustee to avoid a transfer by a debtor made with actual or constructive fraudulent intent).

<sup>12</sup> *Id.* § 547(b)(1) (allowing a trustee to avoid a transfer by a debtor that gives preference to one creditor over another). Many of the cases cited in this Note analyze the "no harm, no foul" approach under both § 547 and § 548. In this Note, however, only § 548 is analyzed, although both provisions are treated the same for purposes of the "no harm, no foul" framework. *See In re Wickstrom*, 113 B.R. at 351 ("[N]o distinction should be drawn based upon whether the trustee asserts a preferential transfer or a fraudulent conveyance has taken place.").

<sup>13</sup> *Id.* § 522; *see also* Dana Yankowitz, Comment, "I Could Have Exempted It Anyway": Can a Trustee Avoid a Debtor's Prepetition Transfer of Exemptible Property?, 23 EMORY BANKR. DEV. J. 217, 218 (2006).

<sup>14</sup> *See id.* § 522(g); *cf.* *Lockwood v. Exch. Bank of Fort Valley*, 190 U.S. 294, 299 (1903) (holding that the bankruptcy estate never succeeded to the debtor's exempt property).

Part II addresses the split of authority among the United States Circuit Courts of Appeals as to whether a trustee can avoid a pre-petition transfer of otherwise exempt property. Part III argues that the minority “no harm, no foul” approach is the best approach for courts to take when analyzing pre-petition transfers of exempt property under the Bankruptcy Code. On the basis of this argument, Part IV recommends amending § 548(a)(1) to reflect the “no harm, no foul” approach.

## I. STATUTORY LANGUAGE AND LEGISLATIVE HISTORY

The Bankruptcy Code aims to protect creditors' interests in the debtor's bankruptcy estate by allowing a trustee to avoid certain transfers of property.<sup>15</sup> This system serves as a safeguard against other provisions of the Code that allow the debtor to protect certain assets from the reach of creditors during bankruptcy proceedings.<sup>16</sup> These opposing goals serve as the main source of conflict for the differing views of courts regarding a debtor's pre-petition transfer of exempt property.<sup>17</sup>

### A. *Statutory Provisions*

#### 1. Fraudulent Conveyances

Many debtors facing bankruptcy seek to transfer assets to a third party to keep property out of the reach of creditors. One way debtors seek to accomplish this goal is by having the third party transfer the asset back to the debtor after bankruptcy proceedings have concluded, which allows the debtor to escape the consequences of bankruptcy scot-free. The starting point for a trustee to avoid such a transfer by a debtor is 11 U.S.C. § 548(a)(1), the fraudulent conveyance provision.<sup>18</sup> Section 548(a)(1) of the Bankruptcy Code provides:

The trustee may avoid any transfer . . . of an interest of the debtor in property, or any obligation . . . incurred by the debtor, that was made or incurred on or within 2 years before the date of the filing of the petition, if the debtor voluntarily or involuntarily—

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<sup>15</sup> 11 U.S.C. § 548(a)(1).

<sup>16</sup> *Id.* §§ 522(b)(2), 544(b)(1).

<sup>17</sup> See *infra* Part II; see also 11 U.S.C. § 547 (preferential transfers); *id.* § 548 (exemption provisions).

<sup>18</sup> 11 U.S.C. § 548(a)(1).

(A) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted; or  
(B)(i) received less than a reasonably equivalent value in exchange for such transfer or obligation; and  
(ii)(I) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation . . . .<sup>19</sup>

Thus, under § 548(a)(1)(A), a trustee can avoid any transfer by a debtor which was transferred with the "actual intent to hinder, delay, or defraud" creditors within two years of filing for bankruptcy.<sup>20</sup> Section 548(a)(1)(B) allows a trustee to avoid constructively fraudulent transfers in which a debtor's exchange of property was for less than a reasonably equivalent value and made while the debtor was either insolvent or rendered insolvent by the transfer.<sup>21</sup>

Under 11 U.S.C. § 544(b), a bankruptcy trustee has whatever avoiding powers an unsecured creditor with an allowable claim might have under applicable state or federal law.<sup>22</sup> Courts have interpreted § 544(b) as allowing a trustee to use applicable state law to avoid a transfer as fraudulent under the federal Bankruptcy Code.<sup>23</sup> Most states have adopted the Uniform Fraudulent Transfer Act, which has now been renamed the

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<sup>19</sup> *Id.* Note that § 548(a)(1)(A) refers to actual fraud, while § 548(a)(1)(B) refers to constructive fraud. *Id.*

<sup>20</sup> *Id.* § 548(a)(1)(A).

<sup>21</sup> *Id.* § 548(a)(1)(B)(i)–(ii)(I). The statute also avoids constructively fraudulent transfers if the debtor's exchange of property was less than a reasonably equivalent value and made while the debtor intended to become insolvent by the transfer or if a debtor was left with unreasonably small capital by a transfer pursuant to a debtor's engagement in a business transaction. *Id.* § 548(a)(1)(B)(i), (ii)(II), (ii)(III).

<sup>22</sup> *Id.* § 544(b)(1).

<sup>23</sup> *Malone v. Short (In re Short)*, 188 B.R. 857, 859 (Bankr. M.D. Fla. 1995).

Uniform Voidable Transaction Act<sup>24</sup> (“UVTA”), which will govern a trustee’s power to avoid a transfer as fraudulent under § 544(b). The UVTA has similar avoidance language to § 548.<sup>25</sup>

## 2. Exemptions

The Bankruptcy Code allows the debtor to exempt certain assets from the bankruptcy estate. Section 522 allows the debtor to exempt property which could be exempted under applicable state law.<sup>26</sup> Most states have specified exemptions for debtors under state law—most notably, the homestead exemption.<sup>27</sup> Additionally, although the Code allows the debtor to choose between exemptions under federal or state law, most states require a debtor to use applicable state law when exempting property.<sup>28</sup> However, the Bankruptcy Code does limit the exemptions which can be taken by a debtor. Under § 522, a debtor’s aggregate interest in exempt property cannot exceed \$22,975.<sup>29</sup>

The exemption provisions of the Bankruptcy Code promote important interests of bankruptcy law. They give the debtor a safety net and further the goal of allowing the debtor a “fresh start” after filing for bankruptcy.<sup>30</sup> These provisions ensure that

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<sup>24</sup> To date, forty-three states and the District of Columbia have adopted the Uniform Fraudulent Transfer Act (“UFTA”)—which has now been renamed the Uniform Voidable Transactions Act and includes some changes from the UFTA—in state legislation. See *Legislative Fact Sheet—Fraudulent Transfer Act—Now Known as Voidable Transactions Act*, UNIFORM LAW COMMISSION, <http://www.uniformlaws.org/LegislativeFactSheet.aspx?title=Fraudulent%20Transfer%20Act%20-%20now%20known%20as%20Voidable%20Transactions%20Act> (last visited Jan. 26, 2015).

<sup>25</sup> See Uniform Voidable Transactions Act § 4(a) (2014). The UVTA provides “badges of fraud” to determine whether a conveyance by a debtor is voidable by a creditor. *Id.* § 4(b)(2) (listing factors that the official comments to § 4 refer to as “badges of fraud”). Note that the newly adopted UVTA has changed the language of the UFTA, which referred to fraudulent transfers instead of voidable transactions. See Uniform Fraudulent Transfer Act § 4(a) (1985).

<sup>26</sup> 11 U.S.C. § 522(b)(2).

<sup>27</sup> See, e.g., FLA. CONST. art. X, § 4(a)(1) (Florida homestead exemption); LA. REV. STAT. ANN. § 20:1 (2015) (Louisiana homestead exemption); MASS. GEN. LAWS ch. 188, § 1 (2015) (Massachusetts homestead exemption).

<sup>28</sup> See Eric A. Posner, *The Political Economy of the Bankruptcy Reform Act of 1978*, 96 MICH. L. REV. 47, 123 (1997).

<sup>29</sup> 11 U.S.C. § 522(d)(1).

<sup>30</sup> See *Stellwagen v. Clum*, 245 U.S. 605, 617 (1918).

a debtor and his family are not destitute following proceedings and have some way of rejoining normal economic society in the future.<sup>31</sup>

### 3. Debtor's Bankruptcy Estate

The language of 11 U.S.C. § 541 defines the property which constitutes the debtor's estate at the commencement of a bankruptcy proceeding.<sup>32</sup> This language provides the source of conflict which has divided the circuit courts on the issue of whether a pre-petition transfer of otherwise exempt property can be avoided by a trustee as a fraudulent transfer. Section 541 provides, in relevant part, that "[t]he commencement of a case . . . creates an estate. Such estate is comprised of . . . all legal or equitable interests of the debtor in property as of the commencement of the case."<sup>33</sup>

This section provides that the debtor's bankruptcy estate is comprised of all the debtor's interests in property at the commencement of the bankruptcy proceedings.<sup>34</sup> As discussed in Part II, the courts place a great deal of emphasis on this provision of the Code when determining whether a conveyance is fraudulent under § 548(a)(1). The classification of a debtor's pre-petition transfer of property will turn largely on whether courts read § 541 as prohibiting debtors from transferring property until after they file for bankruptcy, including property otherwise exempt from creditors under state law.

#### B. Legislative History

The treatment of a debtor's exempt property has continuously evolved under federal bankruptcy laws since the introduction of the Bankruptcy Act in 1898. Congress has amended the language of the bankruptcy laws to reflect the changing characterization of the bankruptcy estate, and it has instituted limitations on state-established exemptions for the debtor.<sup>35</sup> The history of federal bankruptcy law illustrates the

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<sup>31</sup> *See id.*

<sup>32</sup> *See* 11 U.S.C. § 541.

<sup>33</sup> *Id.* § 541(a)(1).

<sup>34</sup> *Id.*

<sup>35</sup> *See* Posner, *supra* note 28, at 100–01 (discussing how the Bankruptcy Reform Act of 1978 created a minimum floor for federal exemptions, allowing debtors to choose between state exemptions and federal exemptions).



source of federal courts' divergent views on the treatment of a debtor's pre-petition transfer of property and on the role of state law in determining a debtor's fate.

### 1. Bankruptcy Act of 1898

The Bankruptcy Act of 1898 ("1898 Act") explicitly incorporated state exemption allowances.<sup>36</sup> Under the 1898 Act, the bankruptcy estate never succeeded to the debtor's exempt property.<sup>37</sup> Additionally, the 1898 Act disallowed characterizing a debtor's transfer as fraudulent if state law exempted the property from the debtor's estate.<sup>38</sup> Later amendments to the Bankruptcy Act made this result more apparent by defining property of a debtor that could be fraudulently conveyed as inclusive of only his nonexempt property.<sup>39</sup>

State exemption laws varied greatly at the time the 1898 Act was in effect.<sup>40</sup> The lack of consistency led to a call for the creation of a uniform system of exemptions.<sup>41</sup> However, federal and state interests divided sharply over exemption policy because the states historically controlled this realm of bankruptcy law.<sup>42</sup> Federal bankruptcy law continued to incorporate state exemptions immediately preceding the enactment of the Bankruptcy Reform Act of 1978<sup>43</sup> ("1978 Reform Act"). Federal exemptions did exist, but while they supplanted many state exemptions, "the federal exemptions did not play a significant role in bankruptcy cases."<sup>44</sup>

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<sup>36</sup> See *id.* at 63.

<sup>37</sup> See *id.*

<sup>38</sup> See Yankowitz, *supra* note 13, at 224–25. Property fraudulently conveyed by a bankrupt debtor "shall . . . be and remain a part of the assets and estate of the bankrupt" but only if "the same is not exempt from execution and liability for debts by the law of his domicile." *Id.* at 225 (quoting Bankruptcy Act of 1898, ch. 541, § 67(e), 30 Stat. 544 (repealed 1978)).

<sup>39</sup> See G. Stanley Joslin, *Insolvency in Bankruptcy: A Synthesis*, 38 IND. L.J. 23, 26 (1962).

<sup>40</sup> Posner, *supra* note 28, at 63 ("Many exemption statutes were archaic, singling out bibles, guns, crops, or farm animals. They reflected the rural origins of states that had since become highly urbanized. Some allowed debtors to waive the exemptions in a contract, others did not. Some allowed debtors to avoid liens, others did not.")

<sup>41</sup> *Id.*

<sup>42</sup> *Id.* at 94–95.

<sup>43</sup> *Id.* at 95.

<sup>44</sup> *Id.*

## 2. 1978 Revisions

### *a. Treatment of State Exemption Law*

The 1978 Reform Act marked a significant effort by Congress to establish a more uniform set of exemption laws for bankruptcy proceedings brought under federal law.<sup>45</sup> This Act created what is considered the modern-day Bankruptcy Code. However, Congress’s attempt did not fully solve the problem, and the House Bill that was eventually passed established a set of federal exemptions but gave the debtor the right to choose between federal and state exemptions.<sup>46</sup> The federal exemptions essentially provided a “floor” for debtors—they included a \$10,000 dollar exemption limit for the homestead and a \$5,000 exemption limit for miscellaneous personal property.<sup>47</sup> With the passage of the Bankruptcy Code, Congress in effect ceded to state power and “franchis[ed] exemption policy to the states.”<sup>48</sup>

### *b. Treatment of the Debtor’s Estate Under § 541(a)(1)*

Although the 1978 Reform Act left exemption law in the hands of the states, it altered judicial treatment of state exemption law through other changes. The primary example of this alteration can be seen in the language of § 541(a)(1) following the 1978 revisions. Under the newly established Bankruptcy Code, the debtor’s bankruptcy estate succeeds to “all legal or equitable interests of the debtor in property as of the commencement of the case.”<sup>49</sup> Thus, § 541(a)(1) has the effect of overruling case law interpreting the 1898 Act.<sup>50</sup> The Supreme Court has interpreted the 1898 Act as explicitly excluding property exempted under state law from the debtor’s assets in a

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<sup>45</sup> *See id.* at 99–101.

<sup>46</sup> *Id.*; *see also* 11 U.S.C. § 522 (2012).

<sup>47</sup> Posner, *supra* note 28, at 100–01.

<sup>48</sup> *Id.* at 108. Congress’s retreat from uniformity and its institution of a floor may have been a result, in part, of the influence of state officials. *See id.* at 105. Additionally, state governments are perceived to have more information about local interests than the federal government, which allows the states to satisfy local interests more successfully through tailored exemption laws. *Id.* at 105–06.

<sup>49</sup> 11 U.S.C. § 541(a)(1).

<sup>50</sup> *See Lasich v. Wickstrom (In re Wickstrom)*, 113 B.R. 339, 350 (Bankr. W.D. Mich. 1990).

bankruptcy proceeding.<sup>51</sup> Under the 1978 Reform Act, however, property of the estate includes "all property of the debtor, even that needed for a fresh start."<sup>52</sup>

The enactment of § 541(a)(1) marks the point of controversy that fuels the current circuit split over pre-petition transfers of exempt property. Although § 522(b) allows a debtor to elect the use of state exemption law, § 541(a)(1) defines the debtor's estate as all interests of the debtor in property. It is difficult to determine how these provisions coincide and the ultimate effect this has on fraudulent conveyances under § 548(a)(1). For example, § 522 allows a debtor to opt out of the federal exemption scheme and elect to use state law exemptions. This allowance implies that pre-petition transfers of property cannot be considered fraudulent conveyances if they are allowed under the state law that applies to the debtor.<sup>53</sup> However, § 541 and § 548(a)(1), when read alone, seem to bar pre-petition transfers. Section 541 states that a debtor's bankruptcy estate consists of all interests of the debtor in property,<sup>54</sup> and § 548(a)(1) allows a trustee to avoid "any transfer . . . of an interest of the debtor in property."<sup>55</sup> This reading appears to give the bankruptcy court jurisdiction over a debtor's exempt property and to allow pre-petition transfers to be avoided as fraudulent.<sup>56</sup>

## II. CIRCUIT SPLIT

Since the inception of the Bankruptcy Code, circuit courts have been divided over whether a debtor's pre-petition transfer of otherwise exempt property constitutes a fraudulent conveyance under § 548. The majority of courts have held that a trustee can avoid such a transfer under § 548(a)(1). However, a minority of courts have applied the "no harm, no foul" doctrine and have refused to let a trustee avoid a pre-petition transfer if the property would be exempt under applicable state law.

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<sup>51</sup> *Lockwood v. Exch. Bank of Fort Valley*, 190 U.S. 294, 299 (1903).

<sup>52</sup> S. REP. NO. 95-989, at 82 (1978).

<sup>53</sup> *See* 11 U.S.C. § 522(b)(1).

<sup>54</sup> *See id.* § 541(a)(1).

<sup>55</sup> *Id.* § 548(a)(1).

<sup>56</sup> *See id.*

### A. *Majority Position: The Wickstrom Approach*

The majority of circuit courts have held that a trustee can avoid a debtor's pre-petition transfer of potentially exempt property under the Bankruptcy Code ("Code"). This determination is based on two main arguments: (1) The "no harm, no foul" approach to § 548 is misguided, and (2) language in the Bankruptcy Code would be rendered superfluous by the adoption of the "no harm, no foul" approach.<sup>57</sup>

#### 1. "No Harm, No Foul" Rejected

The majority of circuits disagree with the "no harm, no foul" approach because they believe that the minority of courts prematurely dismiss the interests of the creditor in state-law exempt property.<sup>58</sup> According to the majority, all property, even potentially exempt property, is part of the bankruptcy estate reachable by creditors under § 541 until the debtor claims an exemption.<sup>59</sup> Thus, the majority of circuit courts believes that "no harm, no foul" is inconsistent with the Bankruptcy Code.<sup>60</sup>

For example, in the seminal case of *Lasich v. Wickstrom*,<sup>61</sup> the debtor transferred real property and money to his parents and son approximately three months before he filed for bankruptcy.<sup>62</sup> The trustee of the debtor's estate sought to recover the transfers as a fraudulent conveyance under § 548(a).<sup>63</sup> The transferees contended that the transferred property was exempt under state law, and therefore the creditors could not be harmed by the transfers.<sup>64</sup> The court acknowledged the divergent decisions by courts on pre-petition transfers of potentially exempt property under the Code.<sup>65</sup> However, the court refused to adopt

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<sup>57</sup> See *Tavener v. Smoot*, 257 F.3d 401, 406–07 (4th Cir. 2001) (upholding the majority approach for two reasons: "§ 522(g) of the Bankruptcy Code apparently anticipates this result . . . [and] the 'no harm, no foul' approach is misguided").

<sup>58</sup> See, e.g., *id.* at 407.

<sup>59</sup> See 11 U.S.C. § 541(a)(1) ("[An] estate is comprised of . . . all legal or equitable interests of the debtor in property as of the commencement of the case."); see also *Tavener*, 257 F.3d at 407.

<sup>60</sup> See, e.g., *Tavener*, 257 F.3d at 407.

<sup>61</sup> 113 B.R. 339 (Bankr. W.D. Mich. 1990).

<sup>62</sup> *Id.* at 341–42.

<sup>63</sup> *Id.* at 340 (noting that the trustee also sought to recover the transfers as preferential transfers under § 547(b)).

<sup>64</sup> *Id.* at 346.

<sup>65</sup> *Id.* at 346–47.

the “no harm, no foul” approach.<sup>66</sup> It stated that a transfer must be analyzed “in accordance with what happened” and not on the hypothetical assertion that the creditors would not have been able to reach the exempt property.<sup>67</sup> The court concluded that “‘no harm, no foul’ . . . seem[s] to ignore the possible rights that creditors have in potentially exempt property.”<sup>68</sup>

Courts following the *Wickstrom* approach seek to protect the creditor’s interest in potentially exempt property based on the argument that a debtor’s actions can never be determined with complete certainty. In other words, a court cannot predict which property a debtor will exempt.<sup>69</sup> For example, in *Tavener v. Smoot*,<sup>70</sup> the debtor received a settlement from his employer for a work-related injury under the Federal Employer’s Liability Act.<sup>71</sup> The debtor transferred the settlement into an account held by a corporation of which his wife and children were the sole shareholders.<sup>72</sup> He filed for bankruptcy several months later and claimed an exemption for the settlement money he had transferred.<sup>73</sup> The trustee sought to avoid the debtor’s transfer of the settlement funds as fraudulent.<sup>74</sup>

The Fourth Circuit explicitly rejected the “no harm, no foul” approach based on its “misguided” nature.<sup>75</sup> The court summarized its view of the flawed reasoning behind the minority approach:

Under a statutory scheme in which all property is presumed to be part of the bankruptcy estate, and no property is exempt until such time as the debtor claims an exemption for it, creditors *can* be harmed by transfers of potentially exempt property because it is not a foregone conclusion that such property will be exempt from the estate. Potentially exempt property can be used to satisfy the demands of the creditors if the debtor never claims the exemption.<sup>76</sup>

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<sup>66</sup> *Id.* at 352.

<sup>67</sup> *Id.* at 346.

<sup>68</sup> *Id.* at 348.

<sup>69</sup> *See id.* at 346.

<sup>70</sup> 257 F.3d 401 (4th Cir. 2001).

<sup>71</sup> *Id.* at 404–05.

<sup>72</sup> *Id.*

<sup>73</sup> *Id.* at 405.

<sup>74</sup> *Id.*

<sup>75</sup> *Id.* at 407.

<sup>76</sup> *Id.*

The United States Court of Appeals for the Fourth Circuit agreed with the *Wickstrom* court's rejection of "no harm, no foul" based on the potential rights of creditors.<sup>77</sup> Additionally, the court noted that § 548 did not require that a fraudulent conveyance cause actual harm to a creditor, nor does § 548 exclude transfers of exempt property from its scope.<sup>78</sup>

Lastly, the debtor in *Sullivan v. Welsh*<sup>79</sup> transferred her homestead to her parents less than one year before she filed for bankruptcy.<sup>80</sup> The trustee sought to avoid the transfer as a fraudulent conveyance under § 548(a).<sup>81</sup> The bankruptcy court held that because the homestead was exempt under state law, it was not capable of being fraudulently transferred, and therefore its transfer could not be avoided under the applicable state law.<sup>82</sup> The United States Court of Appeals for the Eighth Circuit rejected the lower court's argument, and the "no harm, no foul" approach completely, in favor of the *Wickstrom* approach.<sup>83</sup> The court held that "while state law determines the nature of a debtor's interest in property, it does not determine whether a transfer of that interest is fraudulent under § 548."<sup>84</sup> Accordingly, the court held that § 548 does not apply to property which would have been exempt because this approach is inconsistent with the structure of the Bankruptcy Code.<sup>85</sup>

## 2. Majority Support for § 522(g)

Courts following the *Wickstrom* approach find support in § 522(g) of the Bankruptcy Code for their position that a debtor's pre-petition transfer of exempt property should be avoidable by a trustee. Section 522(g) provides:

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<sup>77</sup> *Id.*

<sup>78</sup> *Id.* ("[F]or if a debtor enters into a transaction with the express purpose of defrauding his creditors, his behavior should not be excused simply because, despite the debtor's best efforts, the transaction failed to harm any creditor.").

<sup>79</sup> 457 B.R. 748 (B.A.P. 8th Cir. 2011).

<sup>80</sup> *Id.* at 751.

<sup>81</sup> *Id.* at 751–52.

<sup>82</sup> *Id.* at 752.

<sup>83</sup> *Id.* at 754.

<sup>84</sup> *Id.* at 753 ("[I]f the Bankruptcy Court is correct that courts are to look to the same state fraudulent transfer law under § 548 as under § 544, then no purpose would be served by § 548."). Thus, a trustee is not limited by applicable state law under § 548(a), even though the trustee would be limited by the applicable state law available to an unsecured creditor with an allowable claim under § 544(b). *See id.*

<sup>85</sup> *Id.* at 754.

Notwithstanding sections 550 and 551 of this title, the debtor may exempt under subsection (b) of this section property that the trustee recovers . . . to the extent that the debtor could have exempted such property under subsection (b) of this section if such property had not been transferred, if—

(1)(A) such transfer was not a voluntary transfer of such property by the debtor; and

(B) the debtor did not conceal such property . . . .<sup>86</sup>

While there is no explicit language in the Code that voluntary transfers are avoidable, courts that follow the *Wickstrom* approach interpret the Code in this way based on Congress's choice to include involuntary transfers.<sup>87</sup> For example, the court in *Tavennner v. Smoot*<sup>88</sup> relied upon this language as an indication that Congress intended for a trustee to be able to avoid a debtor's transfer of exempt property.<sup>89</sup> The *Tavennner* court reasoned that a debtor should be denied an exemption for property transferred in these cases because "§ 522(g) . . . apparently anticipates this result."<sup>90</sup> Because § 522(g) allows a debtor to exempt property in certain circumstances, such as in the case of an involuntary transfer, the majority of courts reasons that Congress purposely decided not to allow a debtor recourse under the Code for his voluntary prepetition transfer of exempt property.<sup>91</sup>

### *B. Minority Position: "No Harm, No Foul" Under the Treiber Approach*

The minority of courts continue to adhere to the "no harm, no foul," or diminution of estate, approach. Under this theory, a transfer of property that a debtor would have been able to claim as exempt is not considered fraudulent under § 548. Because the

<sup>86</sup> 11 U.S.C. § 522(g) (2012).

<sup>87</sup> See *id.*; see also Yankowitz, *supra* note 13, at 232 ("Section 522(g) does not explicitly state that a trustee can avoid a debtor's prepetition transfer of exemptible property. But it provides that the debtor can exempt such recovered property if the requisite factors are fulfilled under subsection (1). This presupposes that the trustee can avoid the transfer in the first place.").

<sup>88</sup> 257 F.3d 401 (4th Cir. 2001).

<sup>89</sup> *Id.* at 406–07.

<sup>90</sup> *Id.* at 406.

<sup>91</sup> See *id.* at 406–07; see also *In re Gingery*, 48 B.R. 1000, 1004 (Bankr. D. Colo. 1985) ("A literal reading of Section 522(g) compels the conclusion that a recovered asset cannot be exempted if it was transferred voluntarily regardless of whether or not such transfer was concealed.").

debtor would have been able to exempt the property and remove it from the reach of his creditors, his creditors are no worse off as a result of the transfer than they would have otherwise been absent the transfer.<sup>92</sup> Thus, the assets the creditor would have received are not diminished in any capacity.

### 1. Background of "No Harm, No Foul"

The United States Court of Appeals for the Seventh Circuit initially addressed the issue of pre-petition transfers of exempt property in *In re Agnew*.<sup>93</sup> In *In re Agnew*, a debtor transferred his interest in his homestead, which he and his wife had both held as tenants by the entirety, to his wife, and his wife subsequently sold the home.<sup>94</sup> The creditor argued that the court should deny the debtor discharge because his transfer was made with the intent to defraud his creditors and to remove the proceeds from the sale of the property from the reach of his creditors.<sup>95</sup> The Seventh Circuit stated that in order for the court to deny discharge, the creditor must show that the debtor transferred property, which reduced the assets available to the creditor, and that the transfer was made with fraudulent intent.<sup>96</sup> Because state law exempted entire property and proceeds from its sale from the reach of creditors, the court held that it was impossible to conceive of a logical reason to hold that a conveyance of property not

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<sup>92</sup> See, e.g., *Lee Supply Corp. v. Agnew (In re Agnew)*, 818 F.2d 1284, 1289–90 (7th Cir. 1987); *Kapila v. Fornabaio (In re Fornabaio)*, 187 B.R. 780, 782–83 (Bankr. S.D. Fla. 1995); *Jarboe v. Treiber (In re Treiber)*, 92 B.R. 930, 933–34 (Bankr. N.D. Okla. 1988).

<sup>93</sup> See generally *In re Agnew*, 818 F.2d 1284.

<sup>94</sup> *Id.* at 1286.

<sup>95</sup> *Id.* Note that the debtor brought his claim in this case under 11 U.S.C. § 727(a)(2), which has essentially the same language as the fraudulent conveyance language in § 548(a). See *id.* Section 727(a)(2) prohibits the court from denying a debtor discharge under certain circumstances:

[I]f the debtor, with intent to hinder, delay, or defraud a creditor . . . has transferred, removed, destroyed, mutilated, or concealed, or has permitted to be transferred, removed, destroyed, mutilated, or concealed—

(A) property of the debtor, within one year before the date of the filing of the petition; or

(B) property of the estate, after the date of the filing of the petition . . .

11 U.S.C. § 727(a)(2)(A)–(B) (2012).

<sup>96</sup> *In re Agnew*, 818 F.2d at 1289.



subject to the claims of creditors could be fraudulent.<sup>97</sup> Accordingly, it ruled in favor of the debtor and denied the creditors' claims.<sup>98</sup>

The case which first set forth the "no harm, no foul" argument is *Jarboe v. Treiber*<sup>99</sup> ("In re Treiber"). In *In re Treiber*, a debtor transferred his one-half interest in his homestead property to his wife within one year of filing for bankruptcy.<sup>100</sup> The trustee of the estate attempted to avoid the conveyance, but the court found in favor of the debtor because the homestead was exempt under state law.<sup>101</sup> The court determined that no creditor was harmed when the subject of a transfer was potentially exempt property because the creditors would not share in the value of the property even if it had not been conveyed.<sup>102</sup> "In short,—no harm, no foul."<sup>103</sup>

The *Treiber* court found that even if the trustee were to avoid the conveyance, the debtor and his family would still have a homestead exemption in the property which would be superior to any rights of the trustee.<sup>104</sup> Accordingly, the court would not allow the creditors to indirectly defeat the homestead interest of the debtor's family where they could not do so under state law.<sup>105</sup>

Similarly, the debtor in *In re Fornabaio*<sup>106</sup> executed a deed relinquishing his rights to his homestead property in favor of his wife.<sup>107</sup> The trustee sought to avoid the conveyance, asserting that the debtor transferred the property "with the intent to hinder, delay or defraud his creditors."<sup>108</sup> The court, while noting the divergent views on whether exemptible property could be avoided by a trustee, held in favor of the debtor.<sup>109</sup> The court expressly disagreed with the *Wickstrom* line of cases which

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<sup>97</sup> *Id.* at 1289–90.

<sup>98</sup> *Id.* at 1290.

<sup>99</sup> 92 B.R. 930 (Bankr. N.D. Okla. 1988).

<sup>100</sup> *Id.* at 931.

<sup>101</sup> *Id.* at 933–34.

<sup>102</sup> *Id.* at 932.

<sup>103</sup> *Id.*

<sup>104</sup> *Id.*

<sup>105</sup> *Id.* at 934 ("To hold otherwise would simply allow the husband's creditors to indirectly, through the trustee, defeat the homestead interests of the wife and family when they could not do this acting their own.")

<sup>106</sup> *Kapila v. Fornabaio (In re Fornabaio)*, 187 B.R. 780 (Bankr. S.D. Fla. 1995).

<sup>107</sup> *Id.* at 781.

<sup>108</sup> *Id.* Note that this case was also brought under 11 U.S.C. § 727(a)(2). See discussion *supra* note 96.

<sup>109</sup> *In re Fornabaio*, 187 B.R. at 782–83.

allowed for avoidance of transfers of potentially exempt property, stating, "The Bankruptcy Code was not enacted to penalize debtors for filing bankruptcy."<sup>110</sup> The court refused to join the majority of courts because it reasoned it would be penalizing the debtor for an otherwise legal action under the homestead exemption laws of the state.<sup>111</sup> It instead adopted the *Treiber* approach of "no harm, no foul."<sup>112</sup>

## 2. "No Harm, No Foul" Application to § 548(a)(1)

Later decisions by courts following the *Treiber* approach applied the "no harm, no foul" language to bankruptcy proceedings brought by trustees under § 548(a)(1) or the intentional fraudulent conveyance provision of the Bankruptcy Code.<sup>113</sup>

In the case of *Malone v. Short*<sup>114</sup> ("*In re Short*"), a trustee obtained a judgment in bankruptcy proceedings against the debtor in state court.<sup>115</sup> The debtor subsequently transferred his joint interest with his wife in his home to sole ownership by his wife.<sup>116</sup> The trustee sought to avoid the debtor's transfer of his interest in the property under § 544(b)<sup>117</sup> and § 548(a)(1), arguing that the debtor transferred the property to his wife with the actual intent to "hinder, delay, or defraud" his creditors.<sup>118</sup> However, the debtor claimed that a transfer of homestead property, which is exempt from the reach of creditors under Florida state law, could not be made with the intent to defraud creditors.<sup>119</sup> The court agreed with the debtor's argument, holding that the transfer could not be avoided under applicable state law and § 544(b) because Florida law exempts the

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<sup>110</sup> *Id.* at 782.

<sup>111</sup> *Id.* at 782–83.

<sup>112</sup> *Id.* at 782.

<sup>113</sup> Because the language of § 548(a) is almost identical to the discharge language in § 727(a)(1), the earlier "no harm, no foul" decisions involving § 727 are directly applicable to avoidance actions under § 548. *See* discussion *supra* note 96.

<sup>114</sup> 188 B.R. 857 (Bankr. M.D. Fla. 1995).

<sup>115</sup> *Id.* at 858.

<sup>116</sup> *Id.*

<sup>117</sup> The trustee's claim under § 544 was that it could avoid transfers avoidable under applicable law, which the court held included state law. *Id.* at 858–59. Here, Florida state law defined a fraudulent transfer as one made with "actual intent to hinder, delay, or defraud" a debtor's creditor. *Id.* at 859.

<sup>118</sup> The trustee's claim under § 548 referenced § 548(a)(1), the fraudulent conveyance provision of the Bankruptcy Code. *Id.*

<sup>119</sup> *Id.* at 858.

homestead from the claims of creditors, and therefore a homestead cannot be transferred with the intent to defraud creditors.<sup>120</sup> The court also held that the transfer could not be avoided under § 548(a)(1) because the property was exempt at the time of the transfer, and the transfer could not have been made with the intent to “hinder, delay, or defraud creditors pursuant to § 548(a)(1).”<sup>121</sup> Thus, the court refused to allow the trustee to avoid the transfer because of the property’s exempt character under state law in accordance with the *Treiber* approach.<sup>122</sup>

More recently, in *Bear, Stearns Securities Corp. v. Gredd*,<sup>123</sup> the United States District Court for the Southern District of New York interpreted the language of § 548(a)(1) in accordance with the “no harm, no foul” approach.<sup>124</sup> The *Gredd* case involved a trustee seeking to recover proceeds from a debtor’s sales of securities within one year of its bankruptcy petition, which the trustee alleged were “transferred fraudulently” under § 548(a)(1)(A).<sup>125</sup> The trustee urged the court to reject the “no harm, no foul” approach put forth by the debtor.<sup>126</sup> However, the court declined to adopt the *Wickstrom* approach and rejected the trustee’s request.<sup>127</sup>

The court based its rejection of the trustee’s reading of § 548(a)(1)(A) on both textual interpretation and policy concerns.<sup>128</sup> First, the court relied on the Supreme Court and Second Circuit Court of Appeals interpretations of “property of the debtor” under § 547(b) of the Code, which both courts found to mean “property that would have been part of the estate had it

<sup>120</sup> *Id.* at 859–60 (holding that there could be no intent to defraud where creditors “would have had no claim to the property whether it was transferred or not”).

<sup>121</sup> *Id.* at 860.

<sup>122</sup> *See id.*

<sup>123</sup> 275 B.R. 190 (S.D.N.Y. 2002).

<sup>124</sup> *Id.* at 192.

<sup>125</sup> *Id.*

<sup>126</sup> *Id.* at 192–93. The trustee argued that this approach was misguided because the plain language of § 548(a)(1)(A) does not require a showing of the diminution of the creditor’s resources and because this requirement would “render section 548(a)(1)(B)—the constructive fraud provision—superfluous.” *Id.* (internal quotation mark omitted).

<sup>127</sup> *Id.* at 193. The court acknowledged that the trustee’s reading of § 548(a)(1)(A) had support in opinions by various courts. *Id.* (citing *Tavener v. Smoot*, 257 F.3d 401, 407 (4th Cir. 2001)).

<sup>128</sup> *Id.* at 193–96.

not been transferred before the commencement of bankruptcy proceedings."<sup>129</sup> While this interpretation pertained to the preferential treatment of creditors under § 547, and not fraudulent conveyances under § 548, the court "construe[d] this language to have the same meaning when it is used in § 548(a)(1)(A)" based on the rules of statutory construction.<sup>130</sup> Thus, for the purposes of § 548(a)(1), the court held that a trustee could only avoid "an interest of the debtor in property" if the asset transfer had "actually harmed creditors."<sup>131</sup>

Second, the *Gredd* court reasoned that its requirement that a fraudulent transfer must actually harm at least one creditor fulfills the "overarching purpose" of the Bankruptcy Code.<sup>132</sup> A fraudulent transfer that does not make a creditor worse off than he would have been had the transfer not occurred "obviously does not offend the policy behind § 548(a)(1)(A)."<sup>133</sup> Accordingly, the court concluded that a creditor must incur actual harm to avoid a fraudulent transfer under § 548.<sup>134</sup> The court also noted that the transferee bears the initial and ultimate burden of proof to demonstrate that the transferred assets were never available to any creditor.<sup>135</sup> This ensures that a court's reading of § 548 is not overly favorable to the debtor.<sup>136</sup>

### III. "NO HARM, NO FOUL" SHOULD TRUMP THE *WICKSTROM* APPROACH

The "no harm, no foul" doctrine under the *Treiber* approach embodies the most logical reading of the Bankruptcy Code when viewed in its entirety. The procreditor stance under the *Wickstrom* approach in these proceedings represents a valiant

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<sup>129</sup> *Id.* at 193–94 (quoting *Begier v. IRS*, 496 U.S. 53, 58 (1990) (internal quotation mark omitted).

<sup>130</sup> *Id.* at 194 (stating that identical words in different parts of the same act are generally understood to have the same meaning absent legislative intent to the contrary).

<sup>131</sup> *Id.*

<sup>132</sup> *Id.* at 195.

<sup>133</sup> *Id.*

<sup>134</sup> *Id.* Because under federal law these funds were not available to satisfy obligations by the debtor, the court denied the trustee's avoidance action. *Id.* at 198.

<sup>135</sup> *Id.* at 196.

<sup>136</sup> Placing the burden on the transferee helps to ensure that the trustee does not have to face the overwhelmingly difficult task of initially proving its diminution of estate when seeking to avoid a transfer. *Id.* Additionally, a transferee will rarely be successful in making such a showing. *See id.*

attempt to ensure that creditors are not harmed by a debtor's early transfer. However, the *Wickstrom* approach is misguided and overreaching in its interpretation of § 548.<sup>137</sup> Based on (1) a plain language interpretation of the relevant provisions of the Bankruptcy Code, (2) the overarching principles of bankruptcy law, and (3) the already-high burden placed on the transferee in pre-petition transfers of exempt property, the *Treiber* approach effectively balances the rights of creditors and debtors in avoidance proceedings while ensuring adherence to both the actual language and overall purpose of the Bankruptcy Code.<sup>138</sup>

### A. Plain Language of the Bankruptcy Code

#### 1. Flaws in the Majority Approach

The *Wickstrom* approach taken by the majority of courts relies heavily on the language of the Bankruptcy Code ("the Code") in reaching the conclusion that pre-petition transfers of exempt property can be avoided as fraudulent conveyances.<sup>139</sup> Courts using the *Wickstrom* approach are correct in stating that the Code does not explicitly provide for removing potentially exempt property from the reach of creditors. However, the Bankruptcy Code also does not explicitly provide for allowing a trustee to avoid such pre-petition transfers.<sup>140</sup> Much of the statutory language relied on under the *Wickstrom* approach only has implicit meaning, which supports the notion that the Bankruptcy Code should not allow for the avoidance of these transfers.<sup>141</sup>

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<sup>137</sup> The majority reads § 548 independently, instead of viewing it in conjunction with the other sections of the Bankruptcy Code, namely § 522 and § 544(b). *See* 11 U.S.C. § 522(b)(1) (2012) (allowing for a debtor to opt out of federally-created exemption rights and use state exemption rights instead); *Id.* § 544(b)(1) (giving the trustee whatever avoiding powers an unsecured creditor with an allowable claim might have under applicable law).

<sup>138</sup> *See infra* Part III.A–C.

<sup>139</sup> *See supra* Part II.A.

<sup>140</sup> Pre-petition transfers are not mentioned anywhere in § 548(a)(1). *See* 11 U.S.C. § 548(a)(1).

<sup>141</sup> *See infra* Part III.A(1)(a)–(b).

a. *Language of § 522(g)*

As discussed in Part II.A.1, the court in *Tavener v. Smoot* relied upon § 522(g)(1) of the Code as an indication of Congress's definitive intent to treat all transfers of exempt property by a debtor as avoidable by the trustee.<sup>142</sup> However, the court did not acknowledge the fact that the beginning language of § 522(g) subjects the trustee to the limitations of § 550 of the Code.

Section 550 of the Code requires the trustee to have recovered the property under § 548 or another applicable provision.<sup>143</sup> If a debtor's pre-petition transfer of potentially exempt property is not fraudulent for the purpose of § 548(a)(1), the trustee cannot avoid the transfer of property as a fraudulent conveyance under § 548(a)(1), and § 522(g)(1) would not apply to the fraudulent conveyance proceeding.<sup>144</sup> Courts that read § 522(g)(1) as always allowing a trustee to avoid a debtor's pre-petition transfer of exempt property are making an assumption: Section 548 already characterizes these transfers as fraudulent.<sup>145</sup> This assumption shows the inherent flaw in this argument taken under the *Wickstrom* line of cases.

b. *The Bankruptcy Act of 1898*

Courts following the *Wickstrom* approach rely primarily on the language of § 541(a)(1), which defines the bankruptcy estate, in allowing a trustee to avoid a debtor's transfer of potentially exempt property.<sup>146</sup> Under § 541(a)(1), the bankruptcy estate is comprised of "all legal or equitable interests of the debtor in property."<sup>147</sup> As noted in Part I, this definition marks a change from the treatment of the estate under the 1898 Act.<sup>148</sup> Under

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<sup>142</sup> *Tavener v. Smoot*, 257 F.3d 401, 406–07 (4th Cir. 2001).

<sup>143</sup> See 11 U.S.C. §§ 22(g)(1), 550(a) (2012).

<sup>144</sup> See *id.* § 550(a).

<sup>145</sup> See *id.* For a court to reach the conclusion that § 522(g)(1) renders a debtor's transfer of exempt property avoidable as a fraudulent conveyance, it is necessary to determine that the trustee has already recovered the property at issue under § 548. See *id.* Without this determination, § 522(g) will never apply to the fraudulent conveyance proceeding. See *id.*

<sup>146</sup> 11 U.S.C. § 541(a)(1); see, e.g., *Lasich v. Wickstrom (In re Wickstrom)*, 113 B.R. 339, 350 (Bankr. W.D. Mich. 1990).

<sup>147</sup> 11 U.S.C. § 541(a)(1).

<sup>148</sup> See *supra* Part I.B.1 (discussing how under the 1898 Act, the trustee never succeeded to the debtor's exempt property); see also *supra* Part I.B.2.b (discussing the introduction of the § 541(a)(1) language to the 1978 Bankruptcy Code).

the *Wickstrom* approach, many courts rely on this change in determining that a trustee can avoid transfers of exempt property.

Courts that have adopted the *Wickstrom* approach acknowledge that under the 1898 Act, property exempted from the bankruptcy estate under state law was unreachable by creditors.<sup>149</sup> However, the courts read § 541(a) as invalidating that approach because “[a]ll” property becomes part of the bankruptcy estate.<sup>150</sup> Therefore, *Wickstrom* courts hold that all property, including potentially exempt property, becomes part of the bankruptcy estate until the debtor claims an exemption.<sup>151</sup> If the debtor transfers the property prior to filing for bankruptcy, the debtor loses the ability to claim the property as exempt.<sup>152</sup>

This argument does not necessarily nullify the entire “no harm, no foul” approach.<sup>153</sup> The language of § 541(a) does bring all assets of the debtor within the bankruptcy estate,<sup>154</sup> which results in the court having the ability to adjudicate the creditor’s rights in those assets.<sup>155</sup> However, the court’s ability to adjudicate these rights does not nullify the “no harm, no foul” approach entirely. Section 541(a)(1) gives the court the ability to adjudicate parties’ rights with respect to exempt property.<sup>156</sup> It does not bar the court from determining that pre-petition disposition of exempt property is not fraudulent because it caused no harm to the creditor.<sup>157</sup>

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<sup>149</sup> See, e.g., *In re Wickstrom*, 113 B.R. at 350.

<sup>150</sup> *Id.* (emphasis omitted).

<sup>151</sup> *Sullivan v. Welsh (In re Lumbar)*, 457 B.R. 748, 754 (B.A.P. 8th Cir. 2011); see also *Tavener v. Smoot*, 257 F.3d 401, 406–07 (4th Cir. 2001).

<sup>152</sup> *In re Lumbar*, 457 B.R. at 754–55.

<sup>153</sup> See *Nino v. Moyer*, 437 B.R. 230, 235 (W.D. Mich. 2009) (holding that while this particular rationale for “no harm, no foul” is no longer valid, its failure does not necessarily “nullify[ed] established . . . precedent”).

<sup>154</sup> See *id.*

<sup>155</sup> *Id.* at 235–36.

<sup>156</sup> See 11 U.S.C. § 541(a)(1) (2012).

<sup>157</sup> *Moyer*, 437 B.R. at 236. The *Moyer* court noted that “no harm, no foul” should possibly be inapplicable to preferential transfers by a debtor, which could harm the creditor, but that that rationale is not persuasive for unrelated fraudulent conveyance proceedings. *Id.* at 237.

## 2. The *Treiber* Approach Correctly Interprets the Plain Language of § 548

### a. *Compliance with Exemption Statutes Cannot Be Fraudulent Under § 548(a)(1)*

Section 548(a)(1) defines two types of fraud: actual fraud<sup>158</sup> and constructive fraud.<sup>159</sup> Actual fraud is when a debtor makes a transfer "with actual intent to hinder, delay, or defraud" a creditor.<sup>160</sup> Constructive fraud is, in relevant part, when a debtor "received less than a reasonably equivalent value in exchange for [a] transfer," and was "insolvent on the date that such transfer was made . . . or became insolvent as a result of such transfer."<sup>161</sup>

Courts following the *Wickstrom* approach have determined that a debtor's pre-petition transfer can be characterized as actual fraud as long as the debtor "had the requisite fraudulent intent."<sup>162</sup> They reason that § 548 does not explicitly require actual harm to the creditor, so a trustee may avoid any transfer made by a debtor with the intent to keep the property from the reach of creditors under § 548(a)(1)(A).<sup>163</sup> Transfers between immediate family members fall into this category and create a "presumption of fraudulent intent" according to the majority.<sup>164</sup>

However, this argument has one major flaw: How can a debtor have the requisite fraudulent intent when he believes he is transferring property in compliance with state exemption law? The majority's attempt at defining actual fraud through the debtor's intent adheres to the language of § 548(a)(1)(A) on the surface, but it ignores the very reason the debtor may be transferring the property in the first place. Where state exemption law prohibits creditors from reaching certain property and a debtor transfers that property, creditors incur no harm because they have no rights to the property. Consequently,

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<sup>158</sup> 11 U.S.C. § 548(a)(1)(A).

<sup>159</sup> *Id.* § 548(a)(1)(B)(i)–(B)(ii).

<sup>160</sup> *Id.* § 548(a)(1)(A).

<sup>161</sup> *Id.* § 548(a)(1)(B)(i)–(B)(ii)(I).

<sup>162</sup> *See Tavenner v. Smoot*, 257 F.3d 401, 407 (4th Cir. 2001).

<sup>163</sup> *Id.* The court described transfers between related parties as being "closely scrutinize[d]" and stated that these transfers create a presumption of actual fraud if made in the absence of adequate consideration. *Id.* at 408.

<sup>164</sup> *Id.*



debtors do not act with fraudulent intent because they believe they have no need to defraud creditors when acting in accordance with state law.<sup>165</sup>

Some courts following the “no harm, no foul” approach under *Treiber* have recognized this flaw in the *Wickstrom* approach’s argument and have disallowed penalization for a debtor’s “otherwise legal action.”<sup>166</sup> If property is exempt under applicable state law, courts following the *Treiber* approach have held that the transfer cannot be avoided as having been made with the intent to hinder, defraud, or delay a creditor automatically;<sup>167</sup> this is because the debtor cannot possess the requisite intent if state law exempts the property.<sup>168</sup>

Furthermore, the constructive fraud provision’s language cannot be used to avoid a transfer of exempt property if a creditor has no valid claim. While the Bankruptcy Code does not define “reasonably equivalent value,” it has been noted that what constitutes a reasonably equivalent value must be determined from the view of the debtor’s creditors.<sup>169</sup> Thus, unless an unsecured creditor is made worse off because the debtor received an amount significantly less than what it paid, no fraudulent transfer has occurred.<sup>170</sup> Under this definition of “reasonably equivalent value,” a creditor with no rights to a debtor’s exempt property cannot be logically made worse off by a debtor’s transfer of the property because they have no stake in exempt property. If the transfer has no effect on the bankruptcy estate, the transfer cannot constitute constructive fraud.<sup>171</sup>

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<sup>165</sup> *Cf. id.* at 407 (“[I]f a debtor enters into a transaction with the express purpose of defrauding his creditors, his behavior should not be excused simply because, despite the debtor’s best efforts, the transaction failed to harm any creditor.”).

<sup>166</sup> *Kapila v. Fornabaio (In re Fornabaio)*, 187 B.R. 780, 782–83 (Bankr. S.D. Fla. 1995).

<sup>167</sup> *Malone v. Short (In re Short)*, 188 B.R. 857, 860 (Bankr. M.D. Fla. 1995).

<sup>168</sup> *See id.*

<sup>169</sup> Jack F. Williams, *Revisiting the Proper Limits of Fraudulent Transfer Law*, 8 BANKR. DEV. J. 55, 80 (1951) (“The focus is on the consideration received by the debtor, not on the value given by the transferee. The purpose of fraudulent transfer law is the preservation of the debtor’s estate for the benefit of its unsecured creditors.” (footnote omitted)).

<sup>170</sup> *Harman v. First Am. Bank of Md. (In re Jeffrey Bigelow Design Grp., Inc.)*, 956 F.2d 479, 484 (4th Cir. 1992).

<sup>171</sup> *Id.* at 485.

b. *Interpretation of § 548(a)(1) Under the Treiber Approach  
Coincides with Other Provisions of the Code*

As discussed in Part I.A, § 544(b)(1) allows for an unsecured creditor to avoid any interest of a debtor in property that is voidable under applicable state law.<sup>172</sup> However, where state law incorporates exemptions for a debtor, the statute disallows the creditor from bringing a claim under § 544(b).<sup>173</sup>

Despite what seems like protection for state exemption laws under § 544(b)(1), courts following the *Wickstrom* approach still allow a trustee to reach otherwise exempt property under § 548(a)(1) solely based on the timing of the transfer. Under the *Wickstrom* approach, courts reason that because the debtor transfers the otherwise exempt property prior to filing for bankruptcy, the debtor relinquishes all exemption rights in the property. It is unclear why the *Wickstrom* courts allow trustees to circumvent the language of § 544(b)(1) and use § 548(a)(1) as a method of reaching a debtor's exempt property. Such a reading of § 548(a)(1) indicates the majority approach's tendency to look at § 548(a)(1) in isolation, instead of in conjunction with other provisions of the Code that provide for allowances of state law exemption.

Under the minority approach, § 548(a)(1) is read in conjunction with the rest of the Code. Thus, § 544(b) and § 548(a)(1) produce similar outcomes. Just as § 544(b) bars a creditor from seeking relief under state law which prohibits such an action, the minority's approach to § 548(a)(1) bars a creditor from seeking relief by characterizing a debtor's transfer as fraudulent where state law provides an exemption to the debtor for the property.<sup>174</sup> Reading § 548(a)(1) as accounting for the state law exemption provisions allowed under § 544(b) results in a more coherent treatment of state law exemptions.<sup>175</sup>

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<sup>172</sup> See *supra* Part I.A.

<sup>173</sup> See *supra* Part I.A.

<sup>174</sup> See *supra* Part II.B.

<sup>175</sup> Where state law exempts certain property from the debtor's bankruptcy estate, a trustee cannot avoid a transfer of that property under § 548(a)(1) because it has no valid claim under applicable state law. See *Malone v. Short (In re Short)*, 188 B.R. 857, 859–60 (Bankr. M.D. Fla. 1995). If read from the majority view, § 548(a)(1) would essentially ignore the language of § 544 because it would disregard state law exemptions in allowing a trustee to avoid such a conveyance. See *id.*

Reading § 548(a)(1) as allowing a debtor's pre-petition transfers of exempt property to be free from a trustee's avoidance action also coincides with § 522(b) of the Code. Section 522(b) allows for an individual debtor to opt out of the federal bankruptcy scheme and to elect to use applicable state law.<sup>176</sup> It therefore makes little sense to read an exclusively federal-controlled exemption scheme into § 548(a)(1) when Congress explicitly provided for states to have significant control in the realm of exemptions as evidenced by its opt-out language.<sup>177</sup> The treatment of § 548(a)(1) under the *Treiber* approach with respect to state exemption provisions logically coincides with the opt-out language in § 522(b). If § 548(a)(1) is given a meaning that does not account for § 522, it makes it unclear why the language of § 522 explicitly allows a debtor to elect to use applicable state law, including state exemption laws.

### B. *Policy Concerns and the Overarching Principles of Bankruptcy Law*

Two of bankruptcy law's central policies or principles are (1) to provide the debtor with a fresh start and (2) to distribute the estate's assets fairly among creditors.<sup>178</sup>

#### 1. A Debtor's Fresh Start

Bankruptcy law seeks to protect a debtor's interests following the completion of a bankruptcy proceeding. The purpose of filing for bankruptcy is for the debtor to obtain "a new opportunity in life . . . unhampered by the pressure and discouragement of preexisting debt."<sup>179</sup> Congress's central purpose in creating the Bankruptcy Code was to ensure this fresh start for debtors, unburdened by preexisting debts.<sup>180</sup> However, the *Wickstrom* approach does little to further this goal.

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<sup>176</sup> 11 U.S.C. § 522(b) (2012).

<sup>177</sup> *See id.*

<sup>178</sup> *BFP v. Resolution Trust Corp.*, 511 U.S. 531, 563 (1994) (Souter, J., dissenting) (citing *Stellwagen v. Clum*, 245 U.S. 605, 617 (1918)).

<sup>179</sup> *Grogan v. Garner*, 498 U.S. 279, 286 (1991) (quoting *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934)) (internal quotation marks omitted).

<sup>180</sup> *Stoltz v. Brattleboro Hous. Auth. (In re Stoltz)*, 315 F.3d 80, 94 (2d Cir. 2002).

Exemption provisions, such as a homestead exemptions, further the debtor's ability to obtain a fresh start by protecting some of the debtor's property from the reach of creditors. Under the *Wickstrom* approach, a debtor can be penalized for adhering to state exemption provisions, which were put in place to protect essential assets regardless of the bankruptcy. Courts following the *Wickstrom* approach punish the debtor solely based on his decision to make a transfer before filing for bankruptcy, instead of waiting until he files. Legislatures specifically enacted exemption legislation to protect the debtor and his need for a fresh start;<sup>181</sup> the *Wickstrom* approach undermines this legislation by allowing a trustee to avoid a debtor's transfer of exempt property where such transfer is allowed under state law.

In contrast to the *Wickstrom* approach, courts should liberally interpret exemption statutes so that a debtor's fresh start is not impaired.<sup>182</sup> By protecting a debtor's transfer of exempt property from creditors with no legal interest in the property, the "no harm, no foul" approach under *Treiber* ensures that the debtor maximizes its ability to have a fresh start at the conclusion of the bankruptcy.<sup>183</sup>

## 2. Creditors' Rights to the Debtor's Bankruptcy Estate

Courts have a duty to ensure equal treatment of all creditors in a bankruptcy proceeding.<sup>184</sup> This duty includes obtaining a "maximum and equitable distribution" for all creditors.<sup>185</sup> However, bankruptcy proceedings provide a forum for the recognition of already-acquired rights,<sup>186</sup> which indicates that bankruptcy proceedings do not create rights for creditors that they did not have prior to the institution of the proceedings.<sup>187</sup>

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<sup>181</sup> See *Sensenich v. Molleur (In re Chase)*, 2005 WL 189711, at \*7 (Bankr. D. Vt. Jan. 27, 2005) (noting that statutes which endanger the debtor's homestead exemption can jeopardize a debtor's fresh start).

<sup>182</sup> See, e.g., *In re Brody*, 297 B.R. 5, 8 (Bankr. S.D.N.Y. 2003).

<sup>183</sup> In contrast, the majority allows trustees with no legal interest in the exempt property transferred by the debtor to create an interest simply due to the timing of the transfer. See discussion *supra* Part II.A.

<sup>184</sup> See *BFP v. Resolution Trust Corp.*, 511 U.S. 531, 563 (1994) (Souter, J., dissenting).

<sup>185</sup> *Id.*

<sup>186</sup> *In re Credit Indus. Corp.*, 366 F.2d 402, 407 (2d. Cir. 1966).

<sup>187</sup> See *id.* ("Bankruptcy does not provide a forum for the realignment of rights or priorities . . .").

The *Treiber* approach to § 548 coincides with this principle of the Bankruptcy Code, as well. Because the purpose of § 548(a)(1) is to prevent a debtor from putting assets otherwise available to creditors out of their reach,<sup>188</sup> a proper reading of § 548(a)(1) would only allow a trustee to avoid a debtor's transfer of property if the creditors had preexisting claims in the debtor's property. If the debtor's property constituted exempt property under applicable state law, creditors should not have a claim to the property. The principles of bankruptcy law would not be furthered by furnishing additional rights to the trustee.<sup>189</sup>

*C. The High Burden on a Transferee Limits Abuse of § 548(a)(1)*

One of the main concerns regarding a debtor's transfer of exempt property prior to bankruptcy is that creditors will not receive the full reimbursement they deserve.<sup>190</sup> However, the court in *Bear, Stearns Securities Corp. v. Gredd* explained how this potential harm is adequately limited by the "no harm, no foul" approach.<sup>191</sup> In *Gredd*, the court stated that the transferee carried the initial and final burden for proving that the creditor was not harmed by the pre-petition transfer, and it set forth the standard that must be met by the transferee to satisfy the court that the creditor was not harmed by the transfer.<sup>192</sup> The court demanded:

[T]he transferee must demonstrate to the satisfaction of the court that the transfer did not (1) reduce the res that would have been available to any creditor or creditors, (2) "hinder, delay, or defraud" any creditor or creditors, nor (3) have any other adverse impact on any creditor or creditors generally.<sup>193</sup>

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<sup>188</sup> See Williams, *supra* note 169, at 63.

<sup>189</sup> See *id.* at 128 ("In our quest to understand fraudulent transfer liability, we often overlook its first principles. At its core, fraudulent transfer law is a debt-collection device and not a revenue-generating tool; its mission is to prevent the unjust diminution of the debtor's estate.")

<sup>190</sup> See, e.g., *Tavener v. Smoot*, 257 F.3d 401, 407 (4th Cir. 2001) ("[C]reditors can be harmed by transfers of potentially exempt property because it is not a foregone conclusion that such property will be exempt from the estate.")

<sup>191</sup> See *Bear, Stearns Sec. Corp. v. Gredd*, 275 B.R. 190, 196 (Bankr. S.D.N.Y. 2003).

<sup>192</sup> *Id.*

<sup>193</sup> *Id.*

The court noted that the trustee already bears a difficult burden because she must prove that the transfer was made with "actual intent" to defraud creditors.<sup>194</sup> It therefore justified the adoption of the diminution of estate approach by explaining that the transferee had the ultimate duty to establish that the creditor was not harmed by the transfer.<sup>195</sup>

Placing the burden of proof on the transferee, instead of the trustee, adequately limits the risk of harm to the creditor that courts following the *Wickstrom* approach often anticipate in their decisions. The transferee cannot get away with such a transfer without consequences. Instead, the transferee must show that the assets were never available to any creditors and that the creditor suffered no harm in a proceeding under § 548(a)(1)(A).<sup>196</sup>

### CONCLUSION

The "no harm, no foul" approach as applied to § 548(a)(1), which denies an avoidance remedy with respect to transfers of otherwise exempt property, should trump the *Wickstrom* approach. If a debtor transfers property prior to the initiation of a bankruptcy proceeding, and that property is protected from the reach of creditors under state exemption law, the creditor incurs no harm and therefore should have no rights to that property. This approach is supported by the plain language of § 548(a)(1) and other relevant provisions of the Bankruptcy Code, the overarching principles of bankruptcy law, and the already-high burden on the transferee to prove that the transfer resulted in no loss to the creditor. Additionally, the Bankruptcy Code has clearly allowed for the application of state exemption provisions in other parts of the statute.<sup>197</sup> Reading § 548(a)(1) in

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<sup>194</sup> *Id.*

<sup>195</sup> *Id.*

<sup>196</sup> *Id.* The *Gredd* court referenced 5 Collier on Bankruptcy at 548–25, which places the burden of showing "a harmless effect when the fraudulent intent is made out" on the transferor-defendant, not the transferee. *Id.* However, regardless of whether the burden is on the transferee or the defendant, the trustee will often prevail due to this high burden by the opposing parties. *See id.* ("If [the trustee] succeeds in demonstrating, which we expect will be rarely . . ."). This will limit any harm to the creditors, which is ultimately what the majority of courts is concerned with.

<sup>197</sup> *See* 11 U.S.C. §§ 522(b)(1), 544(b)(1) (2012).

conjunction with those provisions leads to the logical conclusion that state exemption laws should dictate a trustee's avoidance power in fraudulent conveyance proceedings.

Lastly, an amendment to § 548(a)(1) to reflect the exclusion of a debtor's pre-petition transfer of exempt property from the fraudulent conveyance definition<sup>198</sup> would resolve the ambiguity as to its meaning and thereby ensure a uniform judicial approach to the transfer of exempt property. This solution would also ensure that the Bankruptcy Code coincides with state preference in the realm of exemption law, which is reflected by overwhelming adoption of the UVTA by the states. Therefore, an adoption of the "no harm, no foul" approach under *Treiber* as reflected in a change to § 548(a)(1) would be the most effective resolution to this conflict.

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<sup>198</sup> Where applicable state law provides for such an exemption. *See id.* § 544(b).