

“I COULD HAVE EXEMPTED IT ANYWAY”: CAN A TRUSTEE AVOID A DEBTOR’S PREPETITION TRANSFER OF EXEMPTIBLE PROPERTY?

INTRODUCTION

Imagine a soon-to-be debtor, overwhelmed by his financial obligations: he has lost his job, his bills are piling up, and his creditors keep calling. The anxious soon-to-be debtor might attempt to repay some debt, but ultimately he realizes that these attempts are futile. He learns of the possibility of bankruptcy from a friend, but understands that he could lose most if not all of his assets and property. He looks at his family, imagining the county marshal seizing his house to pay his creditors and his children forced to sleep on the street. Feeling that he has no alternative, the soon-to-be debtor transfers his house to his wife. They hastily draw up a deed, citing a ten dollar payment as consideration for the transfer. Feeling more secure about his family’s future, the soon-to-be debtor hires an attorney and files for bankruptcy. The bankruptcy court appoints a trustee to act in the best interest of the estate, who files suit alleging that the debtor’s transfer of the house was fraudulent. The debtor consults his attorney, who assures him that he could have exempted the house from the estate under state exemption laws so that it could not be used to pay creditors’ claims. The debtor breathes a sigh of relief. After all, why would the court allow the trustee to avoid the transfer and recover the debtor’s house if the house were exemptible anyway? Much to the debtor’s chagrin, however, the court rules that the transfer was fraudulent and the trustee can avoid the transfer and recover the house for the benefit of the estate. The debtor is shocked and asks his attorney, “How can the transfer be fraudulent? I could have exempted it anyway!”

Federal bankruptcy law (“Bankruptcy Code”),¹ founded in equity and subsequently codified, serves two purposes: to allow creditors to share equally

¹ This Comment explores consumer liquidation bankruptcy under chapter 7 of the Bankruptcy Code. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“BAPCPA”) amendments to the Bankruptcy Code are not relevant here because Congress did not significantly change the provisions explored in this Comment. *See* 11 U.S.C.A. §§ 522(g), 544(b), 547(b), 548(a)(1), 551 (West 2005). Consequently, courts are unlikely to analyze the relevant issues differently under BAPCPA-amended federal bankruptcy law than under prior federal bankruptcy law.

in the assets of the debtor's estate and to provide the honest debtor a fresh start.² The equal distribution purpose is achieved when the debtor files for bankruptcy and the debtor's property becomes part of the estate for equal distribution to creditors.³ Furthermore, the appointed trustee is permitted to avoid certain of the debtor's prepetition transfers and recover property so that creditors can share equally in the assets of the estate.⁴ The fresh start purpose is achieved because the debtor can claim certain assets as exempt when he files the petition.⁵ In addition, the debtor's debts are discharged at the conclusion of the bankruptcy proceedings, providing him a fresh start.⁶

A conflict between these two overarching purposes of bankruptcy law arises when a trustee tries to avoid a debtor's prepetition transfer of an asset that the debtor would have otherwise been able to exempt from the estate.⁷ Can the trustee avoid such a transfer and recover the asset to benefit the estate if the debtor could have exempted the asset anyway? Or would allowing the transfer reward the debtor for behavior that federal bankruptcy law discourages and thwart Congress's intent in enacting the transfer avoidance provisions?

Part I of this Comment outlines the transfer avoidance and exemption provisions in the Bankruptcy Code. Part II examines the history and development of the exemption provisions. Before Congress passed the Bankruptcy Reform Act of 1978 ("1978 Act"), courts held that a trustee could not avoid a debtor's prepetition transfer of exemptible property because exemptible property never actually passed to the estate so creditors would never have had any right to the property. Since Congress passed the 1978 Act,

² *Burlingham v. Crouse*, 228 U.S. 459, 473 (1913) ("It is the twofold purpose of the [Bankruptcy Code] to convert the estate of the bankrupt into cash and distribute it among creditors and then to give the bankrupt a fresh start."); *accord* *Kokoszka v. Belford*, 417 U.S. 642, 645 (1974) (quoting *Burlingham*, 228 U.S. at 473); *Stellwagen v. Clum*, 245 U.S. 605, 617 (1918) ("The federal system of bankruptcy is designed not only to distribute the property of the debtor, not by law exempted, fairly and equally among his creditors, but as a main purpose of the act, intends to aid the unfortunate debtor by giving him a fresh start in life, free from debts, except of a certain character, after the property which he owned at the time of bankruptcy has been administered for the benefit of creditors. Our decisions lay great stress upon this feature of the law—as one not only of private but of great public interest in that it secures to the unfortunate debtor, who surrenders his property for distribution, a new opportunity in life.") (citing *Burlingham*, 228 U.S. at 473); *Burgess v. Sikes* (*In re Burgess*), 438 F.3d 493, 497 (5th Cir. 2006) (quoting *Segal v. Rochelle*, 382 U.S. 375, 379 (1966)).

³ *See* 11 U.S.C. § 541 (2000).

⁴ *See id.* § 551.

⁵ *See id.* § 522.

⁶ *See id.* § 727.

⁷ There is no conflict between a trustee's power to avoid a debtor's prepetition transfer of *nonexemptible* property and the exemption provisions. This Comment only analyzes the trustee's power to avoid a debtor's prepetition transfer of *exemptible* property.

however, all of the debtor's property passes to the estate until the debtor claims an exemption. Part III analyzes the case law and the circuit split that has ensued since the passage of the 1978 Act. The minority of courts has continued to hold that a trustee cannot avoid a debtor's prepetition transfer of exemptible property, while the majority of courts has allowed a trustee to avoid such a transfer. Part IV reviews *Tavener v. Smoot*,⁸ a recent case in which the Fourth Circuit upheld the majority view. This Comment concludes in Part V that *Tavener* and the majority are correct: a trustee should be able to avoid a debtor's prepetition transfer of exemptible property. This conclusion is supported by three lines of reasoning: policy based on the overarching principles of bankruptcy law, the text of the Bankruptcy Code, and Congress's stated intent to allow a trustee to avoid such a transfer. Despite these three lines of reasoning, however, the minority of courts has continued to hold that a trustee cannot avoid a debtor's prepetition transfer of exemptible property. Therefore, Part VI suggests that Congress amend the Bankruptcy Code to clearly and explicitly direct courts to allow a trustee to avoid a debtor's prepetition transfer of exemptible property.

I. THE BANKRUPTCY CODE: ITS PURPOSES AND PROVISIONS

The Bankruptcy Code serves two purposes: to allow creditors to share equally in the assets of the estate and to afford the debtor a fresh start.⁹ Transfer avoidance provisions, specifically fraudulent transfer provisions and preferential transfer provisions, allow creditors to share equally in the distribution of the debtor's assets.¹⁰ Exemption provisions, along with the debtor's right to a discharge of his debts at the conclusion of the bankruptcy proceedings, allow the debtor to make a fresh start.¹¹

A. A Trustee's Power to Avoid the Debtor's Prepetition Transfers

To protect creditors and ensure their equal treatment in bankruptcy, a trustee can avoid a debtor's prepetition transfer under certain circumstances.¹²

⁸ 257 F.3d 401 (4th Cir. 2001), *cert. denied*, 534 U.S. 1116 (2002).

⁹ See *Burlingham v. Crouse*, 228 U.S. 459, 473 (1913).

¹⁰ See § 551.

¹¹ *Traer v. Clews*, 115 U.S. 528, 541 (1885) ("The policy of the [Bankruptcy Code] was, after taking from the bankrupt all his property not exempt by law, to . . . enable him to take a fresh start.").

¹² § 551. The trustee's statutory avoiding powers are incorporated in § 551; § 522 (exemptions); § 544 (trustee as lien creditor and as successor to creditors and purchasers); § 545 (statutory liens); § 547

The trustee avoids such transfers to benefit all creditors who are paid out of the estate.¹³ The trustee can recover the property transferred or the value of the property from the initial transferee or any immediate or mediate transferee of the initial transferee.¹⁴ Two types of transfers that a trustee can avoid are fraudulent transfers and preferential transfers.

1. Fraudulent Transfers

A soon-to-be debtor facing debt and impending bankruptcy may be tempted to save as much property and as many assets as possible for himself and his family. For example, the debtor in the Introduction transferred his house to his nondebtor wife for consideration of ten dollars. The debtor intended to keep the property out of the estate, hide it from his creditors, and have his nondebtor wife transfer the property back to him after the court discharged his debts. The Bankruptcy Code allows a trustee to avoid such a prepetition transfer as fraudulent. Under § 548(a)(1),

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

- (A) made such transfer . . . with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made, . . . indebted; or
- (B)(i) received less than a reasonably equivalent value in exchange for such transfer . . . and
 - (ii)(I) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;
 - (II) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital;
 - (III) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured; or
 - (IV) made such transfer to or for the benefit of an insider, or incurred such obligation to or for the

(preferential transfers); § 548 (fraudulent transfers); § 549 (postpetition transactions); § 724(a) (fines, penalties, and forfeitures); and § 506(d) (voiding certain liens).

¹³ *Id.* § 551.

¹⁴ *Id.* § 550(a).

benefit of an insider, under an employment contract and not in the ordinary course of business.¹⁵

A transfer is fraudulent and avoidable if the debtor exhibited actual intent to hinder, delay, or defraud under § 548(a)(1)(A) or what is known as constructive intent under § 548(a)(1)(B). Alternatively, the trustee has the power under § 544(b) to avoid a transfer that any unsecured creditor could avoid under state fraudulent transfer law.¹⁶ Most states have adopted the Uniform Fraudulent Transfer Act (“UFTA”), which sets similar requisites as § 548(a)(1) of the Bankruptcy Code to determine whether a transfer is fraudulent.¹⁷

2. Preferential Transfers

A trustee can also avoid a debtor’s prepetition transfer as preferential under the Bankruptcy Code. A preference is a transfer that gives a creditor “payment of a greater percentage of his claim against the debtor than he would have received if the transfer had not been made and he had participated in the

¹⁵ *Id.* § 548(a)(1).

¹⁶ The Bankruptcy Code provides that “the trustee may avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable under applicable law by a creditor holding an unsecured claim.” *Id.* § 544(b)(1). “Applicable law” has consistently included state law. *Crews v. Carwile (In re Davis)*, 138 B.R. 106, 108 (Bankr. M.D. Fla. 1992).

¹⁷ *See* UNIF. FRAUDULENT TRANSFER ACT, 7A pt. 2 U.L.A. 266–67 (1968). Currently, at least thirty-eight states have adopted the UFTA. *Id.* The UFTA provides eleven nonexclusive factors, known as “badges of fraud,” for courts to consider in determining whether the debtor had actual intent to hinder, delay, or defraud a creditor. *Id.* § 4(b), 7A pt. 2 U.L.A. 302, 303. Courts consider whether:

- (1) the transfer or obligation was to an insider;
- (2) the debtor retained possession or control of the property transferred after the transfer;
- (3) the transfer or obligation was disclosed or concealed;
- (4) before the transfer was made or obligation was incurred, the debtor had been sued or threatened with a suit;
- (5) the transfer was of substantially all of the debtor’s assets;
- (6) the debtor absconded;
- (7) the debtor removed or concealed assets;
- (8) the value of consideration received by the debtor was reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred;
- (9) the debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred;
- (10) the transfer occurred shortly before or shortly after a substantial debt was incurred; and
- (11) the debtor transferred the essential assets of the business to a lienor who transferred the assets to an insider of the debtor.

Id. § 4, 7A pt. 2 U.L.A. 302.

distribution of the assets of the bankrupt estate.”¹⁸ Under § 547(b) of the Bankruptcy Code,

the trustee may avoid any transfer of an interest of the debtor in property—

- (1) to or for the benefit of a creditor;
- (2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
- (3) made while the debtor was insolvent;
- (4) made—
 - (A) on or within 90 days before the date of the filing of the petition; or
 - (B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and
- (5) that enables such creditor to receive more than such creditor would receive if—
 - (A) the case were a case under chapter 7 of this title;
 - (B) the transfer had not been made; and
 - (C) such creditor received payment of such debt to the extent provided by the provisions of this title.¹⁹

Unlike the fraudulent transfer provisions in the Bankruptcy Code, which focus on the debtor’s actual or constructive intent, the debtor’s intent is irrelevant in determining whether a transfer is preferential.²⁰

The purpose of the trustee’s ability to avoid preferential transfers is twofold.²¹ First, preference avoidance discourages creditors, knowing that the debtor is experiencing financial difficulties and fearing that they might not fare well in a bankruptcy payout, from rushing to collect their debts in full prior to the filing of the petition.²² This reprieve from debt collection gives the debtor a grace period during which he can attempt to resolve his financial problems.²³

¹⁸ H.R. REP. NO. 95-595, at 177 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 6138.

¹⁹ 11 U.S.C. § 547(b) (2000). The Bankruptcy Code provides nine exceptions where the trustee cannot avoid a transfer that would otherwise be considered preferential under the provision. *Id.* § 547(c).

²⁰ *See, e.g.,* *Bailey v. Big Sky Motors, Ltd. (In re Ogden)*, 314 F.3d 1190, 1201 (10th Cir. 2002) (“[I]n a preference analysis, it is generally the effect of the transaction, rather than the debtor or creditor’s intent, that is controlling.”); *see also* H.R. REP. NO. 95-598, at 178 (“[T]he requirement that the trustee prove the state of mind of his opponent is nearly insurmountable, and . . . does not further any necessary bankruptcy policy.”).

²¹ *Lindquist v. Dorholt (In re Dorholt, Inc.)*, 224 F.3d 871, 873 (8th Cir. 2000).

²² H.R. REP. NO. 95-598, at 177 (“[C]reditors are discouraged from racing to the courthouse to dismember the debtor during his slide into bankruptcy.”); *see also* *Dorholt*, 224 F.3d at 873.

²³ H.R. REP. NO. 95-598 at 177 (“The protection thus afforded the debtor often enables him to work his way out of a difficult financial situation through cooperation with all of his creditors.”); *see also* 5 COLLIER ON BANKRUPTCY ¶ 547.01 (Alan N. Resnick et al. eds., 15th ed. rev. 2005).

Second, preference avoidance prohibits transfers that allow the preferred creditor to receive more outside of bankruptcy than he would receive in a bankruptcy payout.²⁴ Thus, the preferential transfer provisions further the overarching policy in bankruptcy law that similarly situated creditors²⁵ should be treated equally in the distribution of the debtor's assets from the estate.²⁶

B. Exemptions

The Bankruptcy Code allows the debtor to claim certain assets in the estate as exempt and unavailable to distribute to creditors.²⁷ While the Bankruptcy Code provides that a debtor may choose between federal or state law exemptions, most states have opted out of federal exemptions, thereby requiring the debtor to use state law exemptions.²⁸ Exemption laws further several important social policies related to the debtor's fresh start.²⁹ They provide the debtor with property necessary for his physical survival,³⁰ protect his dignity and cultural and religious identity,³¹ and enable him to rehabilitate himself.³² Exemption laws also enable the debtor to re-enter normal economic life and not fall into new debt.³³ On a practical level, some exemptible property likely has little resale value to creditors, but has enormous sentimental

²⁴ § 547(b)(5).

²⁵ The Bankruptcy Code provides payment to creditors based on classification of their claims. *See id.* § 1129(a)(7)-(8). "Similarly situated" creditors are those creditors that are grouped in the same class (i.e., fully secured creditors, partially secured creditors, unsecured creditors, etc.). The policy of equality of distribution is referred to as "equal treatment of similarly situated creditors" since the distribution provisions of the [Bankruptcy] Code are aimed at maintaining equality within distinct classes of creditors." Rafael I. Pardo, *On Proof of Preferential Effect*, 55 ALA. L. REV. 283, 326 n.11 (2004).

²⁶ H.R. REP. NO. 95-598, at 178 ("Any creditor that received a greater payment than others of his class is required to disgorge so that all [creditors] may share equally."); *see also Dorholt*, 224 F.3d at 873.

²⁷ *See* § 522(d) (providing a full description of exempt property under federal law). Exemption laws can be traced at least as far back as Roman law. Louis Edward Levinthal, *The Early History of Bankruptcy Law*, 66 U. PA. L. REV. 223, 238 (1918). Roman law permitted a debtor to keep certain necessities for day-to-day survival. *Id.* Exemptions in this country stem from English law that prevailed during the colonial period. Alan N. Resnick, *Prudent Planning or Fraudulent Transfer? The Use of Nonexempt Assets to Purchase or Improve Exempt Property on the Eve of Bankruptcy*, 31 RUTGERS L. REV. 615, 620 (1978) [hereinafter *Prudent Planning*].

²⁸ 14 COLLIER ON BANKRUPTCY, *supra* note 23, at ¶ Intro.02, Intro-2, and ¶ Intro.02[3].

²⁹ *Prudent Planning*, *supra* note 27, at 615.

³⁰ Exemptions under both federal and state law typically include a homestead, household furniture, appliances, and food. *Id.* at 622.

³¹ Exemptions may include Bibles, family pictures, wedding rings, seats occupied in places of worship, books, and pets. *Id.* at 624.

³² Exemptions may include tools of the trade, books used in business, and farming implements. *Id.* at 625.

³³ *Id.* at 626.

value to the debtor (such as worn clothing or heirloom jewelry). Without state or federal exemptions, the debtor and his family presumably would be forced to survive on welfare.³⁴ Thus exemptions shift the burden of providing for the debtor's survival and rehabilitation (his fresh start) from society to creditors.³⁵

II. THE EVOLUTION OF EXEMPTION LAWS AND THE CHANGING DEFINITION OF THE ESTATE UNDER THE BANKRUPTCY CODE

The trustee's power to avoid a debtor's prepetition fraudulent or preferential transfer of exemptible property conflicts with the underlying purposes of exemption laws. On one hand, if a debtor is entitled to exempt property to enable him to make a fresh start, it seems that he should be entitled to do what he wants with that property before bankruptcy. On the other hand, bankruptcy law seeks to prohibit the debtor's attempts to keep assets from creditors and discourage the unequal distribution of assets among creditors. How can these two sets of conflicting principles be reconciled? A history of the evolution of exemption laws and the change in the definition of the estate illuminates the basis of courts' long-standing and continuing struggle with this conflict and the ensuing circuit split.

A. *Exemption Laws Under the 1898 Act*

Under the 1898 Act, the debtor retained exemptible property upon filing the petition and that property did not pass to the estate.³⁶ Under section 70(a), Congress explicitly provided that title to exemptible property did not pass to the trustee:

The trustee of the estate of a bankrupt, upon his appointment and qualification, and his successor or successors, if he shall have one or more, upon his or their appointment and qualification, shall in turn be vested by operation of law with the title of the bankrupt, as of the date he was adjudged a bankrupt, *except in so far as it is to property which is exempt . . .*³⁷

In addition, under section 67(e), fraudulently transferred property remained in the estate after the trustee avoided the transfer unless that property was exempt:

³⁴ *Id.*

³⁵ *Id.*

³⁶ See Bankruptcy Act of 1898, Pub. L. No. 696, 30 Stat. 544, §§ 67, 70 (repealed 1978).

³⁷ *Id.* § 70 (emphasis added).

[A]ll property of the debtor conveyed, transferred, assigned, or encumbered [made with the intent and purpose to hinder, delay, or defraud creditors] shall, if he be adjudged a bankrupt, and the same is *not exempt* from execution and liability for debts by the law of his domicile, be and remain a part of the assets and estate of the bankrupt and shall pass to his said trustee³⁸

Sections 70(a) and 67(e) of the 1898 Act made it clear that the debtor retained title to exemptible property and that the title to that property did not pass to the estate. The trustee's role was limited to segregating, identifying, and appraising what was claimed as exempt.³⁹ The debtor, rather than the trustee, retained actual title to that exemptible property.⁴⁰

The Supreme Court noted in *Lockwood v. Exchange Bank* that

[t]he fact that the [1898 Act] confers upon the court of bankruptcy authority to control exempt property . . . affords no just ground for holding that the court of bankruptcy must administer and distribute . . . the very property which the act in unambiguous language declares shall not pass from the bankrupt or become part of the bankruptcy assets.⁴¹

Under the *Lockwood* precedent, courts pointed out that because the debtor's prepetition transfer of exemptible property did not affect the size of the estate and therefore did not affect creditors, the debtor's disposition of the property prior to bankruptcy was of no concern to the trustee or the creditors that the trustee represented.⁴² To allow the trustee to avoid the debtor's prepetition transfer of exemptible property "would afford creditors a right in exempt property prior to bankruptcy which the law does not give them. . . . And, it would deny to the bankrupt the right to accomplish before bankruptcy that which he could clearly do after bankruptcy."⁴³ Exempt property "is always property over which a bankrupt reserves a power of disposition. . . . The law

³⁸ *Id.* § 67 (emphasis added).

³⁹ *Chi., Burlington & Quincy R.R. Co. v. Hall*, 229 U.S. 511, 515 (1913).

⁴⁰ *See id.*

⁴¹ 190 U.S. 294, 299–300 (1903).

⁴² *See, e.g.*, *Rutledge v. Johansen*, 270 F.2d 881, 882 (10th Cir. 1959); *Baumbaugh v. L.A. Morris Plan Co. (In re Frank)*, 30 F.2d 816, 816 (9th Cir. 1929) ("It is therefore of no concern to the general creditors what disposition a bankrupt makes of exempt property, and a mortgage or transfer thereof cannot be treated as a preference, since in no event would the trustee be entitled to the property.") (citation omitted); *Wetzel v. Idaho State Bank (In re Smith)*, 366 F.Supp. 1213, 1217 (D. Idaho 1973) ("[O]ther creditors cannot be heard to complain of a transfer of property to which they had no right . . .").

⁴³ *Rutledge*, 270 F.2d at 882–83.

does not concern itself with the debtor's purposes; it gives him the exemption to use or to abuse, as he wills"⁴⁴

For example, in *Rutledge v. Johansen*, the debtor transferred his exemptible homestead to a creditor approximately four months before filing a bankruptcy petition.⁴⁵ The trustee brought an action to avoid the transfer as a voidable preference.⁴⁶ The court held that the trustee could not avoid the transfer because exemptible property "remains in the bankrupt, [and] does not pass to the trustee."⁴⁷ If the debtor were entitled to exempt property on the date of filing the petition, he should also be entitled to transfer that property as he wished before the date of filing.⁴⁸ Therefore the debtor had the right to transfer the exempt property prior to bankruptcy without committing a voidable preference.⁴⁹ This conclusion, according to the court, was "directly supported by textbook law" and was also "in consonance with the spirit and purpose of the exemption laws as they are honored in bankruptcy."⁵⁰

B. The 1978 Act Changes Exemption Law and the Definition of the Estate

Until 1978, exemptible property remained in the debtor's possession rather than passing to the estate, and courts adopted the *Rutledge* reasoning in holding that a trustee could not avoid a debtor's prepetition transfer of exemptible property.⁵¹ However, exemption laws and the definition of the bankruptcy estate changed with the passage of the 1978 Act. Under the newly enacted § 541(a), "The commencement of a case . . . creates an estate. Such estate is comprised of all the following property, wherever located and by whomever held: . . . all legal or equitable interests of the debtor in property as of the commencement of the case."⁵² Thus, after 1978, *all* of the debtor's property—including nonexemptible property *and* exemptible property—passed to the estate when the debtor filed a bankruptcy petition and remained there until the debtor successfully asserted an exemption claim.⁵³

⁴⁴ *Negin v. Salomon*, 151 F.2d 112, 114 (2d Cir. 1945).

⁴⁵ *Rutledge*, 270 F.2d at 882.

⁴⁶ *Id.*

⁴⁷ *Id.* at 882–83.

⁴⁸ *Id.* at 883.

⁴⁹ *Id.* at 882.

⁵⁰ *Id.*

⁵¹ *See, e.g., Wetzel v. Idaho State Bank (In re Smith)*, 366 F.Supp. 1213 (D. Idaho 1973).

⁵² 11 U.S.C. § 541(a) (2000).

⁵³ *Id.*; *see also, e.g., Satterfield v. Sigmon (In re Mahaffey)*, No. 95-2411, 1996 U.S. App. LEXIS 16419, at *6 (4th Cir. July 10, 1996); *Covey v. United Fed. Sav. & Loan Ass'n of Ill. (In re Owen)*, 104 B.R. 929, 932 (C.D. Ill. 1989); *Vieira v. Pearce (In re Pearce)*, 236 B.R. 261, 267 (Bankr. S.D. Ill. 1999); *Goldberg v. Torell*

III. THE CIRCUIT SPLIT

The statutory change under the 1978 Act seemed to overrule the *Rutledge* court's reasoning for allowing a debtor to transfer exemptible property before filing the petition. Indeed, since the passage of the 1978 Act, a majority of courts has rejected the *Rutledge* conclusion and reasoning. The majority of courts⁵⁴ has held that because exemptible property does not remain in the debtor's possession but instead passes to the estate under § 541(a), the debtor's disposition of exemptible property *is* of concern both to the trustee and to the creditors that the trustee represents. However, despite this change in the law under the 1978 Act and the majority's rejection of *Rutledge*, the minority of courts⁵⁵ has continued to hold that a trustee cannot avoid a debtor's prepetition transfer of exemptible property. The consequence of this split in authority is that debtors, creditors, their attorneys, and trustees remain uncertain whether a trustee can avoid a debtor's prepetition transfer of exemptible property.⁵⁶

A. *The Minority Continues to Hold that a Trustee Cannot Avoid a Debtor's Prepetition Transfer of Exemptible Property*

Since Congress passed the 1978 Act, the minority of courts has continued to hold that a trustee cannot avoid a debtor's prepetition transfer of otherwise exemptible property. These courts rely on the Diminution of Estate doctrine, which has also come to be known as the "No Harm, No Foul" doctrine. The doctrine states that if the debtor had not made the transfer then the property would have come out of the estate when the debtor claimed an exemption, so that property would not have been available for distribution to creditors.⁵⁷ Thus, the debtor's prepetition transfer of such property does not diminish what is available to creditors.⁵⁸ Because the prepetition transfer of exemptible

(*In re Rundlett*), 149 B.R. 353, 358 (Bankr. S.D.N.Y. 1993); *Lasich v. Estate of A. N. Wickstrom* (*In re Wickstrom*), 113 B.R. 339, 347 (Bankr. W.D. Mich. 1990); *Kepler v. Weis* (*In re Weis*), 92 B.R. 816, 820 (Bankr. W.D. Wis. 1988); H.R. REP. NO. 95-598, at 368 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 6324.

⁵⁴ The majority includes the Fourth, Sixth, Ninth, and Tenth Circuits, lower courts in the Seventh and Eight Circuits, and some lower courts in the First, Second, and Eleventh Circuits. *See infra* note 194.

⁵⁵ The minority includes some lower courts in the First, Second, and Eleventh Circuits. *See infra* note 194.

⁵⁶ The issue is especially uncertain in the First, Second, and Eleventh Circuits (where the lower courts diverge) and in the Third and Fifth Circuits (where neither the circuit courts nor the lower courts have ruled on the issue). *See infra* note 194.

⁵⁷ *Jarboe v. Treiber* (*In re Treiber*), 92 B.R. 930, 932 (Bankr. N.D. Okla. 1988).

⁵⁸ *Id.*

property does not adversely affect creditors, the minority of courts has held that the trustee cannot avoid such a transfer.⁵⁹

The seminal case applying the “No Harm, No Foul” doctrine is *Jarboe v. Treiber (In re Treiber)*. In that case, the debtor conveyed his interest in his residence to his wife six months before filing for bankruptcy.⁶⁰ The trustee sought to avoid the transfer, but the court allowed the debtor’s transfer to stand.⁶¹ The residence was exemptible, so the creditors would not have shared in the proceeds of the sale anyway had the debtor not made the transfer.⁶² The court reasoned simply: “In short,—no harm, no foul.”⁶³

Similarly, in *Bear, Sterns Securities Corp. v. Gredd*, the court stated that the purpose of the fraudulent transfer provisions is to preserve the assets of the estate by preventing “the debtor from placing assets beyond the reach of creditors.”⁶⁴ Therefore, the court did not allow the trustee to avoid the debtor’s prepetition transfer of exemptible property because “[a] transfer of property . . . that does not leave any creditor in a worse position than he would have been had the transfer never occurred . . . does not offend the policy behind section 548(a)(1)(A).”⁶⁵

The debtor in *Noland v. Turner (In re Turner)* conveyed her interest in residential property to her husband about one year before filing a bankruptcy petition.⁶⁶ The trustee alleged that the conveyance was a fraudulent transfer.⁶⁷ The court held that the “conveyance [was] valid, regardless of any possible intent to defraud”⁶⁸ because creditors would not have benefited from the property had there been no transfer.⁶⁹

Some courts have held that a transfer that does not adversely affect any creditor cannot even be fraudulent in the first place, and therefore a trustee

⁵⁹ See, e.g., *id.*

⁶⁰ *Id.* at 930.

⁶¹ *Id.* at 930, 932.

⁶² *Id.* at 932.

⁶³ *Id.*; see also *Kapila v. Fornabaio (In re Fornabaio)*, 187 B.R. 780, 782–83 (Bankr. S.D. Fla. 1995) (holding that because creditors would not be able to reach the debtor’s property, allowing the trustee to avoid the transfer would in effect penalize the debtor for an otherwise legal action).

⁶⁴ 275 B.R. 190, 195 (S.D.N.Y. 2002).

⁶⁵ *Id.* The court also based its decision on the text of the 1978 Act fraudulent transfer provisions and preferential transfer provisions. *Id.* at 193–94.

⁶⁶ 45 B.R. 649, 650 (Bankr. S.D. Ohio 1985).

⁶⁷ *Id.*

⁶⁸ *Id.*

⁶⁹ *Id.* at 651.

cannot avoid the transfer under § 548(a)(1).⁷⁰ For example, in *Malone v. Short (In re Short)*, the debtor transferred his interest in his home to his wife six months before filing for bankruptcy.⁷¹ The creditor alleged that the transfer was fraudulent because the debtor made the transfer with actual intent to hinder, delay, or defraud creditors.⁷² The court disagreed and reasoned that because the property was exempt under state law at the time of the transfer, the debtor could not have possessed actual intent to hinder, delay, or defraud creditors.⁷³ Therefore, the trustee could not avoid the transfer as fraudulent.⁷⁴

B. The Majority Holds that a Trustee Can Avoid a Debtor's Prepetition Transfer of Exemptible Property

Since Congress passed the 1978 Act, the majority of courts has held that a trustee *can* avoid a debtor's prepetition transfer of exemptible property. Courts within the majority have relied on different rationales to reach this conclusion. Some courts have rejected the "No Harm, No Foul" doctrine while others have focused on the statutory provisions of the Bankruptcy Code.

1. Courts Reject the "No Harm, No Foul" Doctrine

Some courts in the majority have held that the "No Harm, No Foul" doctrine "puts the cart before the horse" because *all* property becomes part of the estate under § 541(a) until the debtor successfully claims an exemption.⁷⁵ When the trustee avoids the debtor's prepetition transfer of exemptible property the estate is enlarged, even if only for a short time until the debtor actually claims the exemption.⁷⁶ Furthermore, the debtor has a choice to exempt the property, so the creditors' possible rights depend upon the debtor's ultimate decision whether to exempt the property.⁷⁷

For example, in *Lasich v. Estate of A. N. Wickstrom (In re Wickstrom)*, the debtor made a series of transfers and payments to his parents and son within

⁷⁰ See, e.g., *Malone v. Short (In re Short)*, 188 B.R. 857 (Bankr. M.D. Fla. 1995); *T.R. Press, Inc. v. Whitcomb (In re Whitcomb)*, 140 B.R. 396 (Bankr. E.D. Va. 1992); *Discenza v. MacDonald (In re MacDonald)*, 50 B.R. 255 (Bankr. D. Mass. 1985); *Tavormina v. Robinett (In re Robinett)* 47 B.R. 591 (Bankr. S.D. Fla. 1985); *Noland v. Turner (In re Turner)*, 45 B.R. 649 (Bankr. S.D. Ohio 1985).

⁷¹ *Short*, 188 B.R. at 858.

⁷² *Id.* at 858–59.

⁷³ *Id.* at 860.

⁷⁴ *Id.*

⁷⁵ *Goldberg v. Torell (In re Rundlett)*, 149 B.R. 353, 358 (Bankr. S.D.N.Y. 1993).

⁷⁶ *Lasich v. Estate of A.N. Wickstrom (In re Wickstrom)*, 113 B.R. 339, 347 (Bankr. W.D. Mich. 1990).

⁷⁷ *Id.*

three months of filing a bankruptcy petition.⁷⁸ The trustee sued to recover the transfers and payments as fraudulent and preferential.⁷⁹ The court conceded that under the “No Harm, No Foul” approach creditors hypothetically would not have reached the assets had the transfers not been made because the property was exemptible.⁸⁰ However, the court rejected this argument, reasoning that the “No Harm, No Foul” approach was based upon hypothetical facts that did not exist, and courts “must analyze the law in accordance with what happened rather than what might have happened.”⁸¹ The court rejected the “No Harm, No Foul” approach because creditors’ rights depend on the debtor’s choice to exempt the property and it “ignore[s] the possible rights that creditors have in potentially exempt property.”⁸²

Some courts have held that even if the transfer does not adversely affect any creditor, the transfer is per se fraudulent and avoidable if the debtor intended to keep assets from creditors.⁸³ For example, in *First Beverly Bank v. Adeeb (In re Adeeb)*, the debtor transferred property to third parties for nominal or no consideration.⁸⁴ Later, on advice from a bankruptcy attorney, the debtor reversed the transfers and there was no actual injury to creditors.⁸⁵ The court found that the debtor transferred the property with actual intent to hinder, delay, or defraud a creditor because the debtor admitted that he intended to keep the property from his creditors.⁸⁶ Therefore, the actual “lack of injury to creditors is irrelevant,” and the court allowed the trustee to avoid the transfer.⁸⁷

The debtor in *Future Time, Inc. v. Yates* transferred his interest in the family residence to his wife and later admitted that his actions were motivated by a desire to keep the residence throughout the bankruptcy proceeding.⁸⁸ The

⁷⁸ *Id.* at 341–42. The debtor transferred his home and a recreational camp to his son (each for \$100 consideration), and paid his parents \$20,000. *Id.*

⁷⁹ *Id.* at 340.

⁸⁰ *Id.* at 346.

⁸¹ *Id.* The *Wickstrom* court did not elaborate on the important concept that the “No Harm, No Foul” approach was erroneously based on the assumption that the debtor would have exempted the property. This point is discussed later in greater detail. See *infra* Part V.A.1.

⁸² *Wickstrom*, 113 B.R. at 347–48.

⁸³ 5 COLLIER ON BANKRUPTCY, *supra* note 23, at ¶ 548.04; see, e.g., *First Beverly Bank v. Adeeb (In re Adeeb)*, 787 F.2d 1339 (9th Cir. 1986).

⁸⁴ *Adeeb*, 787 F.2d at 1341. The debtor owned and operated several gas stations, and transferred title to some of the property to friends and associates for little or no consideration. *Id.*

⁸⁵ *Id.*

⁸⁶ *Id.* at 1343.

⁸⁷ *Id.*

⁸⁸ 26 B.R. 1006, 1007 (M.D. Ga. 1983).

court acknowledged that the transfer did not in fact reduce the assets available to creditors, but found that the debtor “obviously intended to shield what he thought was valuable property from the claims of his creditors. To hold . . . that there occurred no transfer of property with the intent to hinder creditors . . . would be to reward [the debtor] for his wrongdoing”⁸⁹ Therefore, the court allowed the trustee to avoid the transfer.⁹⁰

Finally, in *Davis v. Davis (In re Davis)*, the debtor deeded his interest in his home to his wife.⁹¹ Shortly thereafter a creditor sued to avoid the transfer.⁹² After consulting a bankruptcy attorney, the debtor reversed the transfer and filed a bankruptcy petition one day later.⁹³ The debtor argued that the transfer of property did not in fact reduce the assets available to creditors, and he therefore could not have intended to hinder, delay, or defraud creditors.⁹⁴ The court held that the creditor *was* harmed because the creditor had presumably incurred legal fees and expenses to bring an action to challenge the fraudulent transfer, and allowed the trustee to avoid the transfer.⁹⁵

Although the *debtor* typically argues that the trustee should not be allowed to avoid the preferential transfer of exemptible property, the preferred creditor might also make this argument to keep the transferred property. In *Warsco v. Ryan (In re Richards)*, the debtor repaid debts owed to his creditors shortly before filing a bankruptcy petition.⁹⁶ The trustee sought to avoid the payments as preferential and recover the money for the benefit of the estate.⁹⁷ The creditors objected, claiming that the debtor could have exempted the funds anyway, so the payment did not adversely affect the other creditors.⁹⁸ The court rejected the creditors’ argument and allowed the trustee to avoid the transfer and recover the payments.⁹⁹ The court reasoned that the right to exempt property is personal to the debtor; it exists for the debtor’s benefit and

⁸⁹ *Id.* at 1009.

⁹⁰ *Id.*

⁹¹ 911 F.2d 560, 560–61 (11th Cir. 1990).

⁹² *Id.* at 563.

⁹³ *Id.*

⁹⁴ *Id.*

⁹⁵ *Id.* at 561–62 n.2.

⁹⁶ 92 B.R. 369, 370 (Bankr. N.D. Ind. 1988). The debtor paid \$3000 to his grandmother and \$2,730.30 to his parents (both on account of antecedent debt) after receiving money from a workman’s compensation claim. *Id.*

⁹⁷ *Id.*

⁹⁸ *Id.*

⁹⁹ *Id.* at 372.

cannot be asserted by others on the debtor's behalf.¹⁰⁰ To allow a creditor to raise the debtor's right to claim an exemption as a defense to a preferential payment would force the debtor to share the right to claim an exemption with creditors which violates the policy behind exemption laws.¹⁰¹

2. Courts Find Support from § 522(g)

Some courts in the majority have allowed a trustee to avoid a debtor's prepetition transfer of exemptible property based on the text of § 522(g) of the Bankruptcy Code.¹⁰² Under § 522(g),

the debtor may exempt . . . property that the trustee recovers [under the trustee's avoiding powers] to the extent that the debtor could have exempted such property . . . 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 property¹⁰³

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.

Some courts have agreed and read § 522(g) as an indication of Congressional intent to allow a trustee to avoid a debtor's prepetition transfer of exemptible property and recover the property for the benefit of the estate. For example, in *In re Gingery*, the debtor transferred real estate to his wife for no consideration shortly before filing a bankruptcy petition.¹⁰⁴ The trustee sought to avoid the transfers as fraudulent and to preclude the debtor from exempting the property.¹⁰⁵ The court relied on § 522(g) and held that because

¹⁰⁰ *Id.*

¹⁰¹ *Id.* The policy behind exemption laws is to protect the debtor and give him a fresh financial start. See *supra* note 2 and accompanying text.

¹⁰² See, e.g., *Hitt v. Glass (In re Glass)*, 164 B.R. 759, 763 (B.A.P. 9th Cir. 1994); *In re Gingery*, 48 B.R. 1000, 1002 (Bankr. D. Colo. 1985).

¹⁰³ 11 U.S.C. § 522(g) (2000).

¹⁰⁴ *Gingery*, 48 B.R. at 1002.

¹⁰⁵ *Id.*

the debtor voluntarily transferred the residence to his wife the trustee could avoid the transfer and the debtor could not claim the residence as exempt.¹⁰⁶

Some courts have held that the debtor cannot exempt the property even if the trustee did not literally “recover” the property.¹⁰⁷ The debtor in *Hitt v. Glass (In re Glass)* conveyed his interest in his residence to his son for “love and affection” and then filed for bankruptcy.¹⁰⁸ After the trustee learned of the transfer and stated his intent to avoid the transfer as fraudulent, the debtor’s son reconveyed the residence back to the debtor for “love and affection.”¹⁰⁹ The debtor then tried to exempt the residence.¹¹⁰ The court pointed out that while the plain meaning of § 522(g) seemed to require a formal adversary proceeding against the transferee to recover the property, literal application of the statute would “produce a result demonstrably at odds with the intentions of its drafters”¹¹¹ A court should not allow the debtor to take actions that frustrate the overarching policy of equal distribution of assets of the estate.¹¹² Congress intended to limit exemptions where a debtor voluntarily transferred property and engaged in fraudulent conduct.¹¹³ The purposes of § 522(g) “should not be frustrated by a technical reading of the word ‘recovers.’”¹¹⁴ Therefore, the court held that the debtor could not exempt the residence.¹¹⁵

IV. *TAVENNER*: THE FOURTH CIRCUIT GETS IT RIGHT

Until 2001, courts in the majority had allowed trustees to avoid debtors’ prepetition transfers of exemptible property based *either* on a rejection of the “No Harm, No Foul” doctrine *or* on the text of § 522(g).¹¹⁶ In 2001, the Fourth Circuit held in *Tavener v. Smoot* that the trustee could avoid the debtor’s prepetition transfer of exemptible property because of *both* the failure of the “No Harm, No Foul” doctrine *and* the text of § 522(g).¹¹⁷ Since 2001, several

¹⁰⁶ *Id.* at 1002, 1004 (“A literal reading of Section 522(g) compels the conclusion that a recovered asset cannot be exempted if it was transferred voluntarily”).

¹⁰⁷ *See, e.g., Glass*, 164 B.R. 759.

¹⁰⁸ *Id.* at 760.

¹⁰⁹ *Id.* at 760–61.

¹¹⁰ *Id.* at 761.

¹¹¹ *Id.* at 763 (quoting *Griffin v. Oceanic Contractors, Inc.*, 458 U.S. 564, 571 (1982)).

¹¹² *Id.* at 764.

¹¹³ *Id.* at 763.

¹¹⁴ *Id.* at 764.

¹¹⁵ *Id.* at 765.

¹¹⁶ *See supra* Part III.B.1–2.

¹¹⁷ *See Tavener v. Smoot*, 257 F.3d 401, 406–07 (4th Cir. 2001).

bankruptcy courts in the Fourth Circuit have recognized and followed the *Tavener* decision.¹¹⁸

In *Tavener*, the debtor received a settlement as compensation for a work-related injury under the Federal Employer's Liability Act.¹¹⁹ The debtor transferred the settlement funds to a corporation whose sole shareholders were his wife and children.¹²⁰ Shortly thereafter, the debtor filed for bankruptcy and claimed the settlement funds as exempt.¹²¹ The trustee filed an adversary proceeding to avoid the transfers as fraudulent and recover the funds.¹²²

The *Tavener* court held that the trustee could avoid the debtor's prepetition transfer as fraudulent and recover the settlement funds for the estate.¹²³ The court gave two reasons for its decision. First, the court concluded that the "No Harm, No Foul" approach was "misguided" because all of the debtor's property, including exemptible property, is presumed to be part of the estate until the debtor claims exemptions.¹²⁴ Creditors can be harmed by the transfer of exemptible property because it is never certain that the debtor will actually exempt such property from the estate.¹²⁵ If the debtor chooses not to claim the exemption, that property can be used to satisfy creditors' claims.¹²⁶ Therefore, the "No Harm, No Foul" approach is "inconsistent with the Bankruptcy Code."¹²⁷ Second, the *Tavener* court reasoned that § 522(g)

¹¹⁸ See *Ivey v. Graham (In re Johnson)*, 336 B.R. 712, 717 (Bankr. M.D.N.C. 2006) ("[T]he . . . 'no harm, no foul' approach was rejected by the Fourth Circuit, and this Court is required to do the same."); *Gold v. Laines (In re Laines)*, No. 04-10020, 2005 Bankr. LEXIS 2267, at *2 (Bankr. E.D. Va. Mar. 23, 2005) ("The Court of Appeals for the Fourth Circuit expressly considered such a federal rule and rejected it.") (citing *Tavener*, 257 F.3d 401); *Anderson v. Hooper (In re Hooper)*, 274 B.R. 210, 215 (Bankr. D.S.C. 2001) ("[T]he Court recognizes the recent Fourth Circuit decision that holds that transfers of potentially exempt property are amenable to avoidance and recovery actions by bankruptcy trustees.") (citing *Tavener*, 257 F.3d at 404-05).

¹¹⁹ *Tavener*, 257 F.3d at 404-05.

¹²⁰ *Id.* at 405. In addition, during the next several months, the debtor used the settlement funds to buy cars for his wife and daughter and a motorcycle for his son, and made payments to himself and his son. *Id.*

¹²¹ *Id.* The settlement proceeds were exempt under Virginia exemption laws, which created a statutory exemption for money recovered in a personal injury action. *Id.* at 406 (citing VA. CODE ANN. § 34-28.1 (1997)).

¹²² *Id.*

¹²³ *Id.* at 406-07. The *Tavener* court first acknowledged the split among courts regarding the issue of a trustee's power to avoid a debtor's prepetition transfer of exemptible property. *Id.* at 406 ("[C]ourts hold 'divergent views regarding whether transfers of exemptible property can be avoided by trustees.'" (quoting *Kapila v. Fornabaio (In re Fornabaio)*, 187 B.R. 780, 782 (Bankr. S.D. Fla. 1995)).

¹²⁴ *Id.* at 407.

¹²⁵ *Id.*

¹²⁶ *Id.*

¹²⁷ *Id.*

of the Bankruptcy Code “permits the debtor to exempt property recovered by the trustee under certain circumstances”¹²⁸ Thus, § 522(g) is “premised on the notion that a bankruptcy trustee can avoid the transfer of exemptible property and recover the property.”¹²⁹ The transfer in this case was voluntary, so § 522(g) prohibited the debtor from exempting the funds after the trustee avoided the transfer and recovered the funds.¹³⁰ Because of both the failure of the “No Harm, No Foul” doctrine and the clear language of § 522(g) of the Bankruptcy Code, the *Tavener* court held that the trustee could avoid the debtor’s prepetition transfer of exemptible property.¹³¹

V. COURTS SHOULD ALLOW A TRUSTEE TO AVOID A DEBTOR’S PREPETITION TRANSFER OF EXEMPTIBLE PROPERTY BASED ON POLICY, TEXT, AND CONGRESSIONAL INTENT

The *Tavener* holding and reasoning are neither original nor novel. Since Congress passed the 1978 Act, the majority of courts had already held that a trustee could avoid a debtor’s prepetition transfer of exemptible property. These courts had all either rejected the “No Harm, No Foul” doctrine or relied on the text of § 522(g). *Tavener* is unique because it relied on *both* lines of reasoning. While each reason by itself is sufficient to allow a trustee to avoid a debtor’s prepetition transfer of exemptible property, *Tavener’s* conclusion is strengthened by both the policy and the text of the Bankruptcy Code. However, both *Tavener* and the majority of the courts neglected to consider that the legislative history of the 1978 Act also illustrates that Congress intended to allow a trustee to avoid a debtor’s prepetition transfer of exemptible property. No court has supported this conclusion with all three lines of reasoning.

A. *The Policies Behind Bankruptcy Law*

A trustee should be able to avoid a debtor’s prepetition transfer of exemptible property based on the policies behind the overarching principles of bankruptcy law. First, the “No Harm, No Foul” doctrine fails because even a debtor’s transfer of exemptible property may adversely affect similarly situated

¹²⁸ *Id.* at 406.

¹²⁹ *Id.* at 407.

¹³⁰ Blanche D. Smith, *Property of the Estate—To Be or Not to Be? That Is the Question the Trustee Asks of Thee Part II*, 22-1 AM. BANKR. INST. J. 36, 49 (2003).

¹³¹ *Tavener*, 257 F.3d at 407.

creditors. Second, bankruptcy law should not reward a dishonest debtor for having actual intent to hinder, delay, or defraud a creditor. Finally, because the Bankruptcy Code directs courts to deny discharge to debtors who exhibited actual intent, a trustee should likewise be able to avoid a debtor's transfer of exemptible property where the debtor exhibited actual intent.

1. *The "No Harm, No Foul" Doctrine Fails*

The "No Harm, No Foul" approach conflicts with the policies behind federal bankruptcy law in three ways. First, in the case of a preferential transfer, although the transfer of the exemptible property might not directly affect the size of the estate, it does adversely affect similarly situated creditors. If a debtor uses otherwise exemptible funds to pay a preferred creditor shortly before filing for bankruptcy, the preferred creditor has received more than he otherwise would have received in a payout. It might be true that the transfer does not affect the size of the estate because presumably the debtor would have exempted the funds anyway. If the debtor had not paid the preferred creditor, however, then the preferred creditor would have simply shared in the remaining assets pro rata with other similarly situated creditors.¹³² Thus, the debtor's payment allows the preferred creditor to receive more than other creditors.¹³³ Although similarly situated creditors receive the same payout in either case, the other creditors receive a smaller percentage of their claim than the percentage that the preferred creditor receives.¹³⁴ The debtor's transfer in this scenario thus enriches the preferred creditor at the expense of similarly situated creditors, and the "No Harm, No Foul" doctrine fails.¹³⁵

Second, the "No Harm, No Foul" doctrine neglects the possibility that if the debtor does not make the transfer, he might not even exempt the property.¹³⁶ The debtor might not exempt the property by choice, out of neglect, on poor advice from counsel, etc. The property would then be available to maximize the estate and to be distributed among similarly situated creditors.¹³⁷ The payment in this scenario clearly affects similarly situated creditors, and the "No Harm, No Foul" doctrine again fails.¹³⁸

¹³² *Warsco v. Ryan (In re Richards)*, 92 B.R. 369, 371 (Bankr. N.D. Ind. 1988).

¹³³ *Id.*

¹³⁴ *Id.*

¹³⁵ *Id.*

¹³⁶ *Id.*

¹³⁷ *Id.*

¹³⁸ *Id.*

Third, the debtor should not get a federal wildcard exemption windfall. In states that have not opted out of the federal exemptions, § 522(d) provides a list of exemptible property under federal bankruptcy law.¹³⁹ In pertinent part, § 522(d) provides:

The following property may be exempt . . . :

- (1) The debtor's aggregate interest, not to exceed \$18,450 in value, in real property or personal property that the debtor or a dependent of the debtor uses as a residence. . . .

. . .

- (5) The debtor's aggregate interest in any property, not to exceed in value \$975 plus up to \$9,250 of any unused amount of the exemption provided under paragraph (1) of this subsection.¹⁴⁰

Collectively these sections might create a windfall for the debtor. Assume that the debtor in the Introduction lives in a state that applies federal exemptions and that the debtor has \$18,450 equity in his house. The debtor argues that he could have exempted his house from the estate anyway, so the transfer does not adversely affect creditors under the “No Harm, No Foul” doctrine. Suppose the court accepts the “No Harm, No Foul” argument and allows the debtor to transfer his house. The debtor would not claim his homestead exemption and would then be entitled under the wildcard exemption to exempt \$9250 of other property (as an unused amount provided under the homestead exemption). The debtor's wife would transfer the house back to the debtor after the bankruptcy proceedings, and the debtor would keep both his house and the \$9250 of other property. It is true that the creditors would never have shared in the proceeds of the house. But by allowing the transfer, the court permits the depletion of the estate by \$9250 and gives the debtor a windfall through the federal wildcard exemption. Creditors who are paid out of the estate are adversely affected, and the “No Harm, No Foul” doctrine again fails.

¹³⁹ See 11 U.S.C. § 522(d) (2000).

¹⁴⁰ *Id.* § 522(d). Section 522(d)(1) is known as the homestead exemption and § 522(d)(5) is known as the wildcard exemption. See 4 COLLIER ON BANKRUPTCY, *supra* note 23, at ¶ 522.09. The purpose of the wildcard exemption is to prevent discrimination against nonhomeowners, and the wildcard exemption may be applied to any property that is considered property of the estate. See *id.* at ¶ 522–25.

2. *Bankruptcy Law Should Not Reward a Dishonest Debtor Who Has Actual Intent to Hinder, Delay, or Defraud Creditors*

The Bankruptcy Code prohibits a debtor from making a prepetition transfer with actual intent to hinder, delay, or defraud a creditor.¹⁴¹ From the beginning, Congress prohibited granting relief to debtors where the debtor exhibited fraud.¹⁴² The Supreme Court also recognized that “[i]t is the purpose of the [Bankruptcy Code] to . . . relieve the *honest* debtor from the weight of oppressive indebtedness and permit him to start afresh free from the obligations and responsibilities consequent upon business misfortunes.”¹⁴³ When a debtor fraudulently transfers with actual intent, he dishonestly intends to shield property from his creditors.¹⁴⁴ A debtor who fraudulently transfers property with actual intent should not be rewarded for his dishonest behavior, and the trustee should be permitted to avoid such a transfer. In addition, the debtor should not be permitted to exempt the recovered property. While the majority of courts has held that a trustee can avoid a debtor’s prepetition transfer of exemptible property, many courts have not decided whether the debtor can subsequently exempt such recovered property from the estate.¹⁴⁵ Only a few courts have held that a debtor cannot exempt the property after the trustee avoided the fraudulent transfer and recovered the property.¹⁴⁶

¹⁴¹ § 548(a)(1)(A).

¹⁴² H.R. REP. NO. 57-13679, pt. 7, at 6940, 6942 (1902) (Congress intended to “exclude beyond peradventure certain liabilities growing out of offenses against good morals” in “the interest of justice and honest dealing and honest conduct”).

¹⁴³ *Williams v. U.S. Fid. & Guar. Co.*, 236 U.S. 549, 554–55 (1915) (emphasis added); *accord* *Wright v. Union Central Life Ins. Co.*, 304 U.S. 502, 514 (1938); *Wetmore v. Markoe*, 196 U.S. 68, 77 (1904) (“Systems of bankruptcy are designed to relieve the *honest* debtor from the weight of indebtedness which has become oppressive and to permit him to have a fresh start in business and commercial life . . .”) (emphasis added).

¹⁴⁴ *Future Time, Inc. v. Yates*, 26 B.R. 1006, 1009 (M.D. Ga. 1983).

¹⁴⁵ *See, e.g., Lasich v. Estate of A.N. Wickstrom* (*In re Wickstrom*), 113 B.R. 339, 346 (Bankr. W.D. Mich. 1990) (holding that the trustee can recover a fraudulent or preferential transfer of exemptible property, but not deciding whether the debtor can exempt the property after the avoidance and recovery).

¹⁴⁶ *See, e.g., Barbera v. Nathan* (*In re Barbera*), No. 97-1459, 1998 U.S. App. LEXIS 13171, at *5 (6th Cir. June 17, 1998) (holding that where the debtor “makes a conscious choice not to treat exemptible property of the estate . . . as exempt, the property loses its exempt status”); *Hitt v. Glass* (*In re Glass*), 164 B.R. 759, 764–65 (B.A.P. 9th Cir. 1994) (holding that the debtor is not entitled to claim an exemption after the trustee avoids the transfer); *Warsco v. Ryan* (*In re Richards*), 92 B.R. 369, 372 (Bankr. N.D. Ind. 1988) (holding that the trustee can recover the money *and* that the debtor cannot exempt the funds because when a debtor voluntarily transfers exemptible property, the debtor has impliedly waived the exemption). The *Tavener* court *implied* that the debtor could not exempt the funds after the trustee avoided the transfer, but did not explicitly rule on the issue. *Tavener v. Smoot*, 257 F.3d 401, 406 (4th Cir. 2001) (“Indisputably, had [the debtor] left the proceeds from the settlement of his FELA suit against [his employer] in his account, he could have exempted those proceeds from his bankruptcy estate under Virginia law, which creates a statutory exemption for money recovered in a personal injury action.”).

To allow the trustee to avoid a transfer and recover property for the benefit of the estate but then allow the debtor to exempt such property would be counterproductive. The trustee would gain a Pyrrhic victory,¹⁴⁷ expending trustee and judicial resources to avoid the transfer for the benefit of the estate so that the debtor can then exempt and ultimately keep the property. The Bankruptcy Code makes clear that a debtor should not be rewarded for intending to hinder, delay, or defraud creditors¹⁴⁸ and both Congress and the Supreme Court have pointed out that the purpose of bankruptcy law is to allow *honest* debtors to start afresh.¹⁴⁹ To fully effectuate the policies behind bankruptcy law, courts should not only allow a trustee to avoid a debtor's prepetition fraudulent transfer of exemptible property made with actual intent, but also should not allow the debtor to subsequently exempt such recovered property.

3. *Courts Deny Discharge to Debtors Who Intend to Defraud Creditors*

The purposes of exemption and discharge provisions under federal bankruptcy law are the same: to give the debtor a fresh start.¹⁵⁰ Just as the debtor is entitled to exempt certain property from the estate for a fresh start,¹⁵¹ the court grants the debtor a discharge of his unpaid debts once the creditors' claims have been paid out of the estate so that the debtor can start afresh.¹⁵² Despite the similar policy rationale behind exemptions and discharge, an inconsistency remains: courts deny discharge to debtors who fraudulently transfer exemptible property¹⁵³ but disagree whether a trustee can avoid such a transfer.

The explanation for this inconsistency is simple: the Bankruptcy Code directs courts to deny discharge to debtors who fraudulently transfer all

¹⁴⁷ A Pyrrhic victory is one "gained at too great a cost." JOHN B. BREMNER, WORDS ON WORDS, A DICTIONARY FOR WRITERS AND OTHERS WHO CARE ABOUT WORDS 308 (1980). The term references King Pyrrhus of Epirus who defeated the Romans in 280 B.C., but suffered severe casualties in the process which eventually cost him the Pyrrhic War. NIGEL BAGNALL, THE PUNIC WARS 264–146 BC 15 (Osprey Publishing 2002).

¹⁴⁸ 11 U.S.C. § 548(a)(1)(A) (2000).

¹⁴⁹ See *supra* notes 142–43 and accompanying text.

¹⁵⁰ Lawrence Ponoroff & F. Stephen Knippenberg, *Debtors Who Convert Their Assets On the Eve of Bankruptcy: Villains or Victims of the Fresh Start?*, 70 N.Y.U. L. REV. 235, 235 (1995) (explaining that the fresh start policy operates through "the dual mechanisms of discharge and exemption").

¹⁵¹ § 522(d).

¹⁵² *Id.* § 727(a).

¹⁵³ See *infra* notes 155–59 and accompanying text.

property (exemptible *and* nonexemptible) made with actual intent,¹⁵⁴ but provides no direction to courts whether a trustee can avoid a debtor's prepetition transfer of such property with actual intent. The Bankruptcy Code specifically states that

[t]he court shall grant the debtor a discharge, unless—

...

(2) the debtor, with intent to hinder, delay, or defraud a creditor or an officer of the state charged with custody of property under this title, has *transferred*, removed, destroyed, mutilated or concealed, or has permitted to be *transferred*, removed, destroyed, mutilated or concealed —

(A) property of the debtor, within one year before the date of the filing of the petition.¹⁵⁵

Courts hold that denial of discharge under § 727(a)(2) based on a finding of actual intent applies to exemptible property as well as nonexemptible property.¹⁵⁶ In *Davis*, the debtor transferred his interest in his family residence to his wife and then filed for bankruptcy.¹⁵⁷ The debtor argued that he should not be denied discharge because the transfer did not reduce the assets available to creditors.¹⁵⁸ The court, however, pointed out that the debtor “obviously intended to shield what he thought was valuable property from the claims of his creditors” and denied the debtor discharge under § 727(a)(2)(A).¹⁵⁹

The Bankruptcy Code directs courts to deny a debtor discharge based on the debtor's actual intent, but does not direct courts to allow a trustee to avoid a debtor's prepetition transfer based on the same actual intent. Because the purpose of exemptions and discharge are the same (to give the debtor a fresh start after bankruptcy), the Bankruptcy Code should also direct courts to allow a trustee to avoid a debtor's prepetition transfer of exemptible property where the debtor exhibited actual intent to hinder, delay, or defraud a creditor.

¹⁵⁴ § 727(a)(2)(A). It is important to note that debtors are denied discharge only for exhibiting actual intent, not constructive intent. *See id.*

¹⁵⁵ *Id.* (emphasis added). Interestingly, the timing in § 727(a) mirrored the timing in § 548(a) before Congress passed BAPCPA (the reachback period of both provisions was one year). *See* §§ 548(a), 727(a). Under BAPCPA, however, Congress changed the reachback period for fraudulent transfers under § 548(a) to two years. *See* 11 U.S.C.A. § 548(a)(1) (West 2005). Congress did not change the reachback period for denying discharge under § 727(a). *See* § 727(a).

¹⁵⁶ *See, e.g.,* *Davis v. Davis (In re Davis)*, 911 F.2d 560, 560–61 (11th Cir. 1990).

¹⁵⁷ *Id.*

¹⁵⁸ *Id.* at 561.

¹⁵⁹ *Id.* at 561–62.

B. The Text of the Bankruptcy Code

The Bankruptcy Code also provides textual support for allowing a trustee to avoid a debtor's prepetition transfer of exemptible property. First, § 522(g) implicitly grants the trustee the power by enumerating the circumstances in which a debtor can exempt recovered property. Second, transfers of exemptible property can never be fraudulent under the UFTA,¹⁶⁰ while the Bankruptcy Code does not make this distinction.¹⁶¹

1. Section 522(g) Implicitly Permits a Trustee to Avoid a Debtor's Prepetition Transfer of Exemptible Property

As discussed in Part III.B.2, many courts in the majority have recognized that § 522(g) gives the debtor the right to exempt property that the trustee recovered if the property were involuntarily transferred away from the debtor (such as by the fixing of a judicial lien) and if the debtor did not conceal the property.¹⁶² Section 522(g) is premised on the assumption that the trustee has the power to avoid such a transfer of exemptible property in the first place.¹⁶³ This provision thus implicitly supports the majority's conclusion that a trustee can avoid a debtor's prepetition transfer of exemptible property.

2. The Trustee Can Avoid a Debtor's Prepetition Transfer of Exemptible Property Even Though Transfers of Exemptible Property Cannot Be Fraudulent Under the UFTA

A trustee can avoid a debtor's fraudulent transfer in two ways. First, the trustee can show the requisite factors under § 548(a)(1), the fraudulent transfer provision.¹⁶⁴ Second, § 544(b) gives the trustee the power to avoid a transfer as fraudulent under state law,¹⁶⁵ and most states have adopted the UFTA.¹⁶⁶

Under the UFTA, a transfer of exemptible property cannot be fraudulent. The UFTA defines "transfer" as "every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with an *asset*

¹⁶⁰ UNIF. FRAUDULENT TRANSFER ACT §§ 1(2), 1(12), 7A pt.2 U.L.A. 275, 276.

¹⁶¹ 11 U.S.C. § 101(54) (2000).

¹⁶² See *supra* Part III.B.2.

¹⁶³ See *supra* Part III.B.2.

¹⁶⁴ See § 548(a)(1)(A)-(B).

¹⁶⁵ *Id.* § 544(b).

¹⁶⁶ See *supra* note 17 and accompanying text.

or an *interest in an asset . . .*”¹⁶⁷ The UFTA limits the definition of “asset” to “property of a debtor, but the term does not include: . . . property to the extent it is generally exempt”¹⁶⁸ A debtor’s disposition of or parting with an exemptible asset is not a transfer under the UFTA, so it cannot be a *fraudulent* transfer.¹⁶⁹ Thus, in the thirty-eight states that have adopted the UFTA, trustees cannot rely on § 544(b) to avoid a debtor’s prepetition transfer of exemptible property.¹⁷⁰

The trustee’s inability to avoid a debtor’s prepetition transfer of exemptible property under § 544(b) is inconsequential because the trustee can still avoid the debtor’s transfer under § 548(a)(1). The Bankruptcy Code defines a “transfer” as “each mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with—(i) property; or (ii) an interest in property.”¹⁷¹ Unlike the UFTA, the Bankruptcy Code neither defines nor distinguishes property as exemptible or nonexemptible.¹⁷² Therefore, while the trustee’s avoiding powers are restricted under most state law because a transfer of exemptible property cannot be fraudulent under the UFTA, the trustee can still avoid such a transfer as fraudulent under § 548(a)(1).

¹⁶⁷ UNIF. FRAUDULENT TRANSFER ACT § 1(12), 7A pt.2 U.L.A. 276 (emphasis added).

¹⁶⁸ *Id.* at 7A pt.2 U.L.A. 275.

¹⁶⁹ The UFTA drafters knew that a transfer of exemptible property could be a fraudulent transfer under the Bankruptcy Code, but intended to exclude such a transfer from being fraudulent under the UFTA. The UFTA drafters state that “[t]he definition of ‘transfer’ is derived principally from . . . the Bankruptcy Code,” and that “[t]he Bankruptcy Reform Act of 1978 has made numerous changes in the section of that Act dealing with fraudulent transfers and obligations, thereby substantially reducing the correspondence of the provisions of the federal bankruptcy law on fraudulent transfers with the [UFTA].” *Id.* at 7A pt.2 U.L.A. 278, 268. The UFTA drafters chose to retain these definitions because they thought that it was “appropriate to exclude property interests that are beyond the reach of unsecured creditors from the definition of ‘asset’ for the purposes of this Act.” *Id.* at 7A pt.2 U.L.A. 276.

¹⁷⁰ Courts agree that, under the UFTA, the disposition of or parting with exemptible property cannot be a fraudulent transfer. For example, in *Rich v. Rich*, the plaintiff creditor sued to avoid the defendant’s transfer of real estate to his wife. 105 S.E.2d 858, 859–60 (W. Va. 1991). The court held that because part of the property was exempt under state homestead exemption laws, it was not an asset under the UFTA definitions, and the lower court should have considered that in determining whether the transfer was fraudulent under the UFTA. *Id.* at 861. Similarly, the court in *Yaesu Elec. Corp. v. Tamura* reasoned that

a [transfer] will not be considered fraudulent if the debtor merely transfers property which is otherwise exempt That is, because the theory of the law is that it is fraudulent for a judgment debtor to divest himself of assets against which the creditor could execute, if execution by the creditor would be barred while the property is in possession of the debtor, then the debtor’s conveyance of that exempt property to a third person is not fraudulent.

33 Cal. Rptr. 2d 283, 286 (Cal. Ct. App. 1994).

¹⁷¹ 11 U.S.C. § 101(54)(D) (2000).

¹⁷² *See id.* § 101 (the Bankruptcy Code does not provide a definition for “property”).

C. Congressional Intent

In 1969, Congress created the Commission on the Bankruptcy Laws of the United States (“Commission”) to “study, analyze, evaluate, and recommend changes to the [1898] Act”¹⁷³ Part I of the Commission’s report contains the Commission’s findings and recommendations, and Part II contains a draft of a bill to implement those recommendations.¹⁷⁴ After hearings on the bill, Congress passed the 1978 Act, marking the most significant change to the Bankruptcy Code since the 1898 Act.¹⁷⁵

1. Congress Intended to Allow a Trustee to Avoid a Debtor’s Prepetition Transfer of Exemptible Property

The Commission acknowledged that under the 1898 Act a debtor’s prepetition payment to a creditor using exemptible property was not a preference and therefore not avoidable.¹⁷⁶ According to the Commission, however, this precedent was undesirable:

There is no valid reason supporting the case law . . . the mere fact that the property used to prefer a creditor may be claimed as exempt does not establish a reason why preference attack is not appropriate. The goals of equality and avoidance of unwise extensions of credit would be furthered by allowing preference attack.¹⁷⁷

The Commission also found that “[t]he only rationale for the cases is that other creditors are not hurt since they are not entitled to expect payment or security from exempt property.”¹⁷⁸ This rationale is unsound, however, because “whether there is a preference or not would be dependent upon whether the debtor selects the property transferred as exempt. But if he did so, since

¹⁷³ Creation of a Commission to Study the Bankruptcy Laws, S.J. RES. 88, 91st Cong. (1969) (enacted). According to Congress, “the bankruptcy system has fallen into disrepair . . . substantially and administratively, the bankruptcy system is straining on all sides to handle situations that the framers of current law never dreamed would arise.” H.R. REP. NO. 95-598, at 4 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5965. The Commission became effective in July 1970 and commenced operating in June 1971. H.R. DOC. NO. 93-137, pt. I, at v (1973); S. REP. NO. 95-989, at 1–2 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5787–88. The Commission filed a final report with the President, Congress, and the Chief Justice of the United States in 1973. H.R. DOC. NO. 93-137, pt. I, at v (1973).

¹⁷⁴ S. REP. NO. 95-989, at 1.

¹⁷⁵ H.R. REP. NO. 95-598, at 3 (“The purpose of the bill is the modernization of the bankruptcy law[s]”).

¹⁷⁶ H.R. DOC. NO. 93-137, pt. I, at 204 (“[T]he rule is now well established that a transfer of exempt property cannot be a preference.”).

¹⁷⁷ *Id.*

¹⁷⁸ *Id.*

voluntarily transferred, the property would be recovered for the benefit of the estate, rather than the debtor.”¹⁷⁹ Thus, the Commission explicitly recommended to Congress that a trustee should be able to avoid a debtor’s prepetition transfer of exemptible property.

2. *Congress Intended that All of the Debtor’s Property Go into the Estate Upon Filing the Bankruptcy Petition*

The Commission also recommended changing the definition of the estate. As discussed in Part II, exempt property did not pass to the estate or vest in the trustee under the 1898 Act.¹⁸⁰ If a trustee recovered exemptible property through transfer avoidance, that property also did not pass to the estate.¹⁸¹ Courts interpreting these provisions under the 1898 Act held that title to the debtor’s exemptible property remained in the debtor’s possession and did not vest in the trustee or pass to the estate, and therefore a trustee could not avoid a debtor’s prepetition transfer of such property.¹⁸²

The Commission redrafted the definition of “property of the estate” and proposed that it include “*all* property of the debtor as of the date of the petition . . . [and] property recovered pursuant to [the preference and fraudulent transfer provisions].”¹⁸³ According to Professor Vern Countryman, a leading bankruptcy expert, “‘It would be preferable to replace [the provisions] with a single provision giving the trustee title, as of the date of bankruptcy’”¹⁸⁴ The Commission followed Countryman’s advice, and noted that “the concept of ‘vesting title by operation of law’ is replaced by the statement that certain property is ‘property of the estate.’”¹⁸⁵

When Congress passed the 1978 Act, it incorporated the Commission’s recommendations regarding the property of the estate.¹⁸⁶ Congress noted that § 541(a)

has the effect of overruling *Lockwood v. Exchange Bank* . . . because it includes as property of the estate all property of the debtor, even

¹⁷⁹ *Id.* at 229 n.148.

¹⁸⁰ *See supra* notes 36–37 and accompanying text.

¹⁸¹ *See supra* note 38 and accompanying text.

¹⁸² *See supra* Part III.A.

¹⁸³ H.R. DOC. NO. 93-137, pt. II, at 147 (1973) (emphasis added).

¹⁸⁴ *Id.* at 148 n.1 (quoting Vern Countryman, *The Use of State Law in Bankruptcy Cases (Part I)*, 47 N.Y.U. L. REV. 407, 473–74 (1972)).

¹⁸⁵ *Id.* at 149 n.2.

¹⁸⁶ *See* 11 U.S.C. § 541(a) (1978).

that needed for a fresh start. After the property comes into the estate, then the debtor is permitted to exempt it under [the exemption provisions] and the court will have jurisdiction to determine what property may be exempted and what remains as property of the estate.¹⁸⁷

Most importantly, under § 541(a) of the 1978 Act, the “estate is comprised of . . . all legal or equitable interests of the debtor as of the commencement of the case,”¹⁸⁸ and includes “interest in property that the trustee recovers under [the fraudulent and preferential transfer provisions]”¹⁸⁹ and “interest in property preserved for the benefit of or ordered transferred to the estate under [the fraudulent and preferential transfer provisions].”¹⁹⁰ In passing the 1978 Act, Congress intended that all of a debtor’s property should pass to the estate upon the debtor filing for bankruptcy, including property that the trustee recovers under the fraudulent and preferential transfer provisions.

VI. CONGRESS SHOULD AMEND THE BANKRUPTCY CODE

A trustee should be allowed to avoid a debtor’s prepetition transfer of exemptible property based on the policies behind bankruptcy law, the text of the Bankruptcy Code, and Congress’s intent in enacting the 1978 Act. The Bankruptcy Code does not explicitly state that the trustee has this power. Section 522(g) implies that a trustee can avoid a debtor’s prepetition transfer of exemptible property.¹⁹¹ The provision, however, is only implicit: courts must infer that the trustee can avoid a transfer of exemptible property because the debtor can exempt such property only under a specific set of circumstances.¹⁹² Congress added § 522(g) to the Bankruptcy Code in 1978, but provided no explanation for adding this provision in the legislative history.¹⁹³ Perhaps Congress simply assumed that courts would understand that a trustee can avoid such a transfer and believed that explanation was unnecessary. This is not as

¹⁸⁷ H.R. REP. NO. 95-598, at 368 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5787, 6324. *Lockwood* held that under the 1898 Act exempt property did not pass to the debtor or to the estate. *See supra* note 37 and accompanying text.

¹⁸⁸ § 541(a)(1).

¹⁸⁹ *Id.* § 541(a)(3).

¹⁹⁰ *Id.* § 541(a)(4).

¹⁹¹ *See supra* Part V.B.1 and Part III.B.2.

¹⁹² *See* § 522(g).

¹⁹³ Section 522(g) first appeared in a proposed bill in the legislative history of the 1978 Act. A Bill to Establish a Uniform Law on the Subject of Bankruptcies, H.R. 6, 95th Cong., (1977). In the legislative history reviewing the bill, Congress reviewed subsections 522(b), (d), and (f), but did not mention § 522(g). *See* H.R. REP. NO. 95-598, at 126 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5787, 6087.

obvious as Congress may have assumed, however, because courts continue to diverge on the issue.¹⁹⁴ Even within the majority, some courts do not cite § 522(g) and rely instead on policy reasons to reach this conclusion. In addition, despite the conflict within the circuits, the Supreme Court denied certiorari in *Tavener*,¹⁹⁵ the most recent case in which a court of appeals addressed the issue. In the absence of clear judicial authority, Congress should act to make clear that a trustee can avoid a debtor's prepetition transfer of exemptible property. Such an amendment would eliminate the confusion that has split the circuits regarding this issue since the passage of the 1978 Act.

CONCLUSION

The transfer avoidance provisions and exemption provisions under the Bankruptcy Code conflict when a trustee seeks to avoid a debtor's prepetition transfer of exemptible property. The exemption provisions entitle the debtor to exempt property from distribution to creditors to make a fresh start. If the debtor is entitled to this property to make a fresh start after bankruptcy, it seems that he should be able to do what he wants with that property before bankruptcy. But the fraudulent transfer provisions prohibit debtors from

¹⁹⁴ The Fourth, Sixth, Ninth and Tenth Circuits join the majority and allow a trustee to avoid a debtor's prepetition transfer of exemptible property. See *Tavener v. Smoot*, 257 F.3d 401 (4th Cir. 2001); *Barbera v. Nathan* (*In re Barbera*), No. 97-1459, 1998 U.S. App. LEXIS 13171 (6th Cir. June 17, 1998); *Mahaffey v. Sigmon* (*In re Mahaffey*), No. 95-2411, 1996 U.S. App. LEXIS 16419 (4th Cir. July 10, 1996); *Fox v. Smoker* (*In re Noblit*), 72 F.3d 757 (9th Cir. 1995); *Redmond v. Tuttle*, 698 F.2d 414 (10th Cir. 1983); *Hitt v. Glass* (*In re Glass*), 164 B.R. 759 (B.A.P. 9th Cir. 1994). Lower courts within these circuits also allow a trustee to avoid a debtor's prepetition transfer of exemptible property. See *Lasich v. Estate of A.N. Wickstrom* (*In re Wickstrom*), 113 B.R. 339 (Bankr. W.D. Mich. 1990); *In re Gingery*, 48 B.R. 1000 (Bankr. D. Col. 1985). The Seventh and Eighth Circuits have not ruled on the issue, but lower courts in these circuits join the majority and hold that a trustee can avoid a debtor's prepetition transfer of exemptible property. See *Covey v. United Fed. Sav. & Loan Ass'n of Ill.*, (*In re Owen*), 104 B.R. 929 (C.D. Ill. 1989); *Vieira v. Pearce* (*In re Pearce*), 236 B.R. 261 (Bankr. S.D. Ill. 1999); *Rimmel v. Goldman* (*In re Goldman*), 111 B.R. 230 (Bankr. E.D. Mo. 1990); *Kepler v. Weis* (*In re Weis*), 92 B.R. 816 (Bankr. W.D. Wis. 1988); *Warsco v. Ryan* (*In re Richards*), 92 B.R. 369 (Bankr. N.D. Ind. 1988). Since the passage of the 1978 Act, no circuit court has joined the minority to hold that a trustee cannot avoid a debtor's prepetition transfer of exemptible property. Within the circuits where the courts of appeal have not ruled on the issue, lower courts in the First, Second, and Eleventh Circuits diverge on the issue. Compare *Bear, Stearns Sec. Corp. v. Gredd*, 275 B.R. 190 (S.D.N.Y. 2002), and *Kapila v. Fornabaio* (*In re Fornabaio*), 187 B.R. 780 (Bankr. S.D. Fla. 1995), and *Malone v. Short* (*In re Short*), 188 B.R. 857 (Bankr. M.D. Fla. 1995), and *Discenza v. MacDonald* (*In re MacDonald*), 50 B.R. 255 (Bankr. D. Mass. 1985), with *Dev. Specialists, Inc. v. Hamilton Bank* (*In re Model Imperial, Inc.*), 250 B.R. 776 (Bankr. S.D. Fla. 2000), and *Goldberg v. Torell* (*In re Rundlett*), 149 B.R. 353 (Bankr. S.D.N.Y. 1993), and *Carpenter v. Valley Wholesale Bldg. Prods. of R.I.* (*In re Carpenter*), 56 B.R. 704 (Bankr. D.R.I. 1986), and *Tanton v. Nolen* (*In re Nolen*), 40 B.R. 6 (Bankr. M.D. Ala. 1984). Neither the circuit courts nor any lower courts within the Third and Fifth Circuits have ruled on the issue.

¹⁹⁵ See *supra* note 8.

attempting to keep assets from creditors, and the preferential transfer provisions prohibit debtors from transferring assets to certain creditors at the expense of similarly situated creditors before filing for bankruptcy.

As this Comment explains, courts should allow a trustee to avoid a debtor's prepetition transfer of exemptible property based on the policies behind federal bankruptcy law. First, the "No Harm, No Foul" doctrine fails because the transfer adversely affects similarly situated creditors. Second, the Bankruptcy Code should not reward dishonest debtors for exhibiting actual intent to hinder, delay, or defraud creditors. Finally, because courts deny discharge to debtors who display actual intent, the Bankruptcy Code should also allow a trustee to avoid a debtor's prepetition transfer if the debtor exhibited actual intent. The text of the Bankruptcy Code also indicates that a trustee can avoid a debtor's prepetition transfer of exemptible property. Section 522(g) is premised on the assumption that the trustee has the power to avoid such a transfer if the requisite factors are met. In addition, although a transfer of exemptible property cannot be fraudulent under the UFTA, the trustee can still avoid a debtor's fraudulent transfer of exemptible property under § 548(a) of the Bankruptcy Code. Finally, there is ample Congressional support in the legislative history of the 1978 Act to sustain this conclusion. Congress determined that a trustee should be able to avoid a preference of exemptible property and that all of the debtor's property passes to the estate until the debtor claims exemptions (including property recovered under the transfer avoidance provisions).

Despite policy support, textual support in the Bankruptcy Code, and Congressional intent, courts continue to reach inconsistent conclusions regarding whether a trustee can avoid a debtor's prepetition transfer of exemptible property. Therefore, Congress should amend the Bankruptcy Code to explicitly direct courts to allow the trustee to avoid such a transfer. Until then, the overarching purposes of bankruptcy law will remain in conflict, and

the debtor in the Introduction of this Comment will be left to wonder why the trustee avoided the transfer and recovered his house for the benefit of the estate if he could have exempted it anyway.

DANA YANKOWITZ*

* Editor-in-Chief, Emory Bankruptcy Developments Journal; J.D. Candidate, Emory University School of Law (2007); B.A. *magna cum laude*, Amherst College (2002). The author would like to thank Professor Julie Schwartz for her guidance. The author is also grateful to her parents, Robert and Rhoda Yankowitz, for their support.