

Smith, Linda S. 87-02145-W 02/19/88
UNITED STATES BANKRUPTCY COURT
For the Southern District of Iowa

In the Matter of

Note: 1988 change in Iowa exemption laws.

LINDA S. SMITH,
dba Mark Smith Standard
Service,

Case No. 87-2145-W

Chapter 7

Debtor.

ORDER ON TRUSTEE'S OBJECTION TO EXEMPTIONS AND
APPLICATION TO COMPEL DEBTOR TO TURN OVER PROPERTY AND
DEBTOR'S RESISTANCE THERETO

On December 15, 1987 the trustee's objection to exemptions came on for telephonic hearing in Des Moines, Iowa. On January 20, 1988 the trustee's application to compel debtor to turn over property and debtor's resistance thereto came on for hearing in Council Bluffs, Iowa. Deborah L. Peterson appeared on behalf of trustee, C.R. Hannan, at the December 15, 1987 hearing. The trustee was present at the January 20, 1988 hearing. David J. McCann appeared on behalf of the debtor at both hearings. At issue in these matters is whether the debtor may convert nonexempt assets into exempt assets on the eve of a bankruptcy filing. The court set a January 8, 1988 deadline for briefs on the exemption issue. Only the debtor has filed a brief. Until the day before the January 20, 1988 hearing, the trustee believed the issue was settled and therefore did not file a brief. The trustee had filed an offer to compromise the dispute that was objected to by an unsecured creditor prior to the hearing. Otherwise these matters have been submitted upon an affidavit of Michael J. Blackmon, documents from

Probate No. 14388 in the Iowa District Court for Page County, various life insurance documents, and a transcript of the debtor's deposition.

FACTS

The debtor and her late husband, Mark L. Smith, operated a gasoline and service station in Shenandoah, Iowa. Mark L. Smith died on July 23, 1986. Sometime thereafter the debtor received \$25,317.30 from a group life insurance policy and \$8,723.27 from an individual policy as a beneficiary. The debtor placed the \$25,317.30 in one savings account and the \$8,723.27 in another. From January 1, 1987 and until the debtor closed the station on August 21, 1987, she used approximately \$8,000.00 of the life insurance proceeds and social security payments to pay business debts.

Beginning in the fall of 1986 the debtor discussed purchasing a life insurance policy with three different life insurance agents. The debtor's attorney advised the debtor to sell a 1969 Chevrolet Camaro and a 1952 Chevrolet and to apply the proceeds, along with the remaining life insurance proceeds, toward the purchase of a life insurance policy. The debtor sold the two vehicles for \$7,000.00.

On August 17, 1987 the debtor used the proceeds from the sale of the vehicles and \$13,000.00 of the remaining proceeds of the group life insurance policy to purchase a single premium life insurance policy on her life. On the date of issue, the policy had a face value of \$87,043.00.

"Maturity Date" is defined in the policy as the date all insurance benefits end and the net cash value of the policy is not less than the face value minus any outstanding debt. The maturity date is specified as August 20, 2054.

The debtor filed bankruptcy on August 27, 1987. On Schedule B-4 the debtor claims an unmaturred life insurance policy exemption in the amount of \$20,000.00 under Iowa Code section 627.6(6). According to her deposition testimony, the debtor purchased the policy to provide for her two sons in the event of her death. Further, the debtor stated she intended to purchase the policy earlier but decided not to do so since she was using insurance money to run the station and was not sure how much money she would need to keep it open.

DISCUSSION

The trustee's objection to exemptions and application to compel debtor to turn over property are based upon the contention that conversion of nonexempt assets into exempt assets on the eve of filing bankruptcy should not be allowed. The trustee has the burden of proving that the debtor's exemption claim is improper. Bankruptcy Rule 4003(c).

The debtor claims the life insurance policy exempt under Iowa Code section 627.6(6) which provides that a debtor may hold exempt from execution "[a]ny unmaturred life insurance policy owned by the debtor, other than a credit

life insurance contract." The trustee first questions whether the policy is "unmatured". Bankruptcy Judge Michael J. Melloy thoroughly examined the meaning of "unmatured life insurance policy" in In re O'Brien, 67 B.R. 317 (Bankr. N.D. Iowa 1986). He concluded that a policy is matured when the insurer is obligated to pay the face amount of the policy which occurs either when the insured dies or the cash value equals the face amount of the policy. Id. at 319. Under this definition, the policy in the instant case is unmatured. The insured is living and the cash value will not equal the face value until 2054.

Also, the trustee argues that conversion of the nonexempt property into the exempt life insurance policy is improper. The trustee does not state in his motion or application why the conversion is improper. Usually in conversion cases, trustees argue that the debtor's act of converting nonexempt assets into exempt assets involved an intent to defraud creditors. At the hearing, the trustee stated that he was "not proceeding on hinder, delay and defraud." Tr. p. 13. Apparently, he contends that conversion of nonexempt assets into exempt assets, by itself, constitutes fraud upon creditors.

Before examining this issue, the court notes that there is no question that the \$13,000.00 in proceeds from the group life insurance policy is an exempt asset. Iowa Code section 509.12 provides:

No policy of group insurance, nor the proceeds thereof, when payable to any

person insured thereunder, or any beneficiary, shall be liable to attachment, garnishment, or other process, or to be seized, taken, appropriated, or applied by any legal or equitable process or operation of law, to pay any debt or liability of such insured person, or beneficiary, or any other person who may have a right thereunder, either before or after payment; nor shall the proceeds thereof, when not made payable to a named beneficiary, constitute a part of the estate of the person insured for the payment of the person's debts.

The trustee has offered no evidence to counter the debtor's statement that the \$13,000.00 used to purchase the life insurance policy were proceeds from a group life insurance policy. Accordingly, the court's inquiry will focus only on the sale of the vehicles and the use of the sale proceeds to purchase the life insurance policy. The debtor concedes that the vehicles in question were not exempt. She cites a number of authorities in support of her position that the eve of bankruptcy conversions of the vehicles are permissible. First, the legislative history of the Code reveals that Congress intended that debtors be allowed to convert property to utilize fully exemptions.

The House and Senate reports state:

As under current law, the debtor will be permitted to convert nonexempt property into exempt property before filing a bankruptcy petition. The practice is not fraudulent as to creditors, and permits the debtor to make full use of the exemptions to which he is entitled under the law.

H.R. Rep. No. 595, 95th Cong., 1st Sess. 361, reprinted in 1978 U.S.
CODE CONG. & ADMIN. NEWS 5963, 6317; S. Rep. No.

989, 95th Cong., 1st Sess. 76, reprinted in 1978 U.S. CODE CONG. & ADMIN. NEWS 5787, 5862.

The Eighth Circuit has recognized that a debtor may make full use of exemptions by converting nonexempt assets into exempt property.

McCormick v. Security State Bank, 822 F.2d 806, 807, n. 2 (8th Cir. 1987); In re Lindberg, 735 F.2d 1087, 1090 (8th Cir. 1984).

Bankruptcy decisions from the Northern District of Iowa have addressed the issue of whether the use of proceeds from the sale of nonexempt property to purchase a life insurance policy constitutes a fraudulent transfer under section 548(a)(1).¹ In In re Breuer, 68 B.R. 48 (Bankr. N.D. Iowa 1985), the debtors liquidated their interests in real estate and used the proceeds to purchase a life insurance policy. The trustee maintained that the debtors made the transaction

¹ 11 U.S.C. section 548(a)(1) provides:

(a) 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 one year before the date of the filing of the petition, if the debtor voluntarily or involuntarily--

(1) 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

with the intent to hinder, delay or defraud creditors in violation of section 548(a)(1). Bankruptcy Judge William A. Hill, sitting by designation, rejected this argument. He stated:

This court, without more, will not find from the fact of conversion alone that conversion of non-exempt assets into exempt assets constitutes fraud on the creditors. Extrinsic facts and circumstances must be in evidence to prove that the conversion of the real property proceeds into life insurance was done with fraudulent intent.

Breuer, 68 B.R. at 50-51 (citation omitted). The court also explained that the trustee's burden of proving fraudulent intent is "very difficult." Id. at 51.

Bankruptcy Judge Michael J. Melloy was confronted with a similar factual situation in In re O'Brien, supra. There, the debtors sold real estate and used the proceeds in part to purchase life insurance policies. The debtors borrowed against the cash value of the policies for payment of family living expenses. The trustee brought a section 548(a)(1) action to invalidate the transfer. The court found that the facts of the case could not be construed as evidence of actual intent to hinder, delay or defraud. The court based this conclusion in part on the proposition that the mere conversion of nonexempt property into exempt property did not constitute fraud upon creditors.

In this case the trustee has adduced no evidence whatsoever to indicate that the debtor acted with fraudulent

intent in selling the vehicles and purchasing a life insurance policy. On the contrary, the record indicates that the debtor converted the property to protect her sons. Based upon the aforementioned authorities, the court will not infer fraudulent intent solely from the act of converting nonexempt assets to exempt assets on the eve of bankruptcy. The trustee bears a heavy burden. He has failed to shoulder that burden.

CONCLUSION AND ORDER

WHEREFORE, for the reasons set forth above, the court finds that the life insurance policy is unmatured and that the debtor's act of selling the vehicles in question and using the proceeds to purchase a life insurance policy was not committed with fraudulent intent.

THEREFORE, the trustee's objection to exemptions is overruled and his application to compel debtor to turn over property is denied.

Signed and filed this 19th day of February, 1988.

LEE M. JACKWIG

CHIEF U.S. BANKRUPTCY JUDGE