In the United States Bankruptcy Court

for the Northern District of Iowa

LYNN JAMES FISCHELS, SHARLA KAY FISCHELS Debtors.	Bankruptcy No. 87-01671W

FINDINGS OF FACT, CONCLUSIONS OF LAW AND ORDER Re: Objection to Exemptions

---

This contested matter proceeding is before the court as a result of an objection filed by The National Bank of Waterloo (hereinafter BANK) to the claim of exemption by the debtors in certain life insurance policies.

What amounted to a preliminary hearing was held on October 1, 1987.

Appearing on behalf of the debtors was their attorney, Michael Dunbar; appearing on behalf of the bank was its attorney, George Keith; and the trustee, Donna Lesyshen, appeared on her own behalf.

The debtors filed their petition under Chapter 7 of the Code on July 31, 1987.

The debtors disclosed in their schedule of personal property (B-2-r) two life insurance policies, one in the amount of $16,000.00 with Alexander Hamilton and the second in the total amount of $1,505.50 with Catholic Foresters.

Both policies were claimed as exempt in the debtors' schedule B-4 under Iowa Code provision 627.6 (7).

On August 27, 1987, the bank filed an objection to the claim of exemption in the life insurance policies to the extent of $7,500.00 in cash surrender value, on the following grounds: That the purchase of the policy or policies resulted from a conversion to debtors' own use of proceeds of collateral secured to the bank.

The bank asked that the debtors' claim of exemption be therefore limited or denied.

The debtors, through their attorney, resisted the objection, Asserting that the sole issue for inquiry as to the validity of the exemption was whether the property was exempt under Iowa law, and that any issue as to the source of the exemption or the manner in which it was created was not an appropriate ground for objection.

The court finds it has jurisdiction of the parties, and finds that this is a core proceeding under 28 U.S.C. section 157(b)(2)(B).

The crux of the bank's objection is that the debtors converted proceeds of collateral pledged to the bank to purchase the life insurance policies, or a portion thereof, now claimed as exempt.

Based on the allegations of the bank, it might have but did not seek to object to discharge of the debtors under 11 U.S.C. section 727(a)(2)(A) or seek a determination of the dischargeability of the indebtedness to the bank based on 11 U.S.C. section 523(a)(6). Instead, the bank has sought a determination from this court that because of the conduct of the debtors in obtaining the exempt property, the claim of exemption should be denied.

As previously stated, the debtors argue that the court's inquiry should be limited to whether the item or items claimed as exempt fall within the literal coverage of the exemption statutes of the state of Iowa. If debtors are correct, the objection would be overruled. But the matter is not that simple.

The exemption scheme of the state of Iowa is contained in Iowa Code Chapter 627. While there are certain exceptions to the potential claims of exemption within the Chapter, there is nothing on the face of the statute which mandates denial of the claim of Exemption based on the conduct of the debtor acquiring the exempt property.

The Iowa exemption law has become important in the bankruptcy context by virtue of 11 U.S.C. section 522(b)(2).

Under the Bankruptcy Act of 1898, courts had held that property could be deprived of its exempt status where there was evidence that the debtor had acquired the property with the intention of defrauding his creditors. Miguel v. Walsh, 447 P.2d 724 (9th Cir. 1971).

This was an exception from the general rule that the conversion of non-exempt to exempt property on the eve of bankruptcy was not inherently fraudulent. Forsberg v. Security State Bank, 15 F.2d 499, 501 (8th Cir. 1926).

These propositions have been carried over under the Code.

The legislative history of 11 U.S.C. section 522 includes Senate Report Number 989, which states as follows:

> 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. (S Rep No. 95-989, 95th Cong, 2d Sess 75-76 (1978)).

While the conversion of non-exempt property to exempt property on the eve of bankruptcy is held not to be in and of itself fraudulent, bankruptcy courts have continued to examine the circumstances surrounding the conversion. This is normally done in adversary proceedings relating to discharge and dischargeability of debts. However the examination of the debtor's motives and actions lith regard to the obtaining of exempt property on the eve of bankruptcy has taken place under the Code in the context of claims of exemptions and objections thereto. In re: Butts, 45 B.R. 34 (Bankr. N.D. 1984); In re: Olson, 45 B.R. 501 (Bankr. Minn. 1984); In re: Hall, 31 B.R. 42 (Bankr. E.D. Tenn. 1983).

In the case of In re: Olson, 45 B.R. 501 (Bankr. Minn. 1984), the court analyzed, within the framework of Minnesota law, the conduct of the debtors in obtaining the exempt property.

In In re: Butta, 45 B.R. 34 (Bankr. N.D. 1984), the court concluded that it was not limited to state law in determining what might be proper objections to a claim of exemption. Id. at 37. The court concluded that pursuant to equitable principles, it could deny a debtor's claim of exemption where "the exempt property was procured prior to bankruptcy filing with an intent to fraudulently remove property from the hands of his creditors." Id. at 38.

While this court agrees with the analysis of the court In re: Butts, it also believes that it should also analyze state law in determining whether the conduct of the debtor in acquiring exempt property should lead to the denial of the exemption. Forsberg **v.** Security State Bank, 15 F.2d 499, 501 (8th Cir. 1926).

There is precious little in the way of Iowa Supreme Court decisions on this issue.

The only case found by the court is that case cited by the bank in its brief--American Savings Bank v. Willenbrock, 228 N.W. 295 (Iowa, 1929).

The facts of that case are not similar enough to the case at land to necessitate a recitation of them.

This court does point out, however, that in its discussion of the case, the Iowa Supreme Court pointed out the following "general rule":

> "* * * that the conversion of non-exempt property into exempt property does not of itself invest the creditor with any right to follow the exempt property." Id. at 299-300. (Emphasis added.)

However tenuous, this court relies on that comment by the Supreme Court that in determining a claim of exemption, a court may go outside the literal language of the statute to analyze the conduct of the debtor in creating the exemption.

This court, therefore, believes that it is within the prerogative of the bankruptcy court to determine whether a claim of exemption may be defeated because of objectionable conduct by the debtor or debtors in obtaining the exempt property.

That the objectionable conduct might also be grounds for denial of discharge or the dischargeability of a debt, does not prevent the creditor from pursuing an objection to exemptions.

Based on the foregoing findings of fact and conclusions of law, the court ORDERS that the objection of the bank to the claim of exemption of the debtors in the life insurance policies be set for final evidentiary hearing.

Dated this 23rd day of October, 1987.

William L. Edmonds
Bankruptcy Judge