

In the United States Bankruptcy Court

for the Northern District of Iowa

BYRON D. SMEBY and LINDA J. SMEBY
Debtors.

Bankruptcy No. X88-00159M
Chapter 11

MEMORANDUM AND ORDER RE: FARM CREDIT SERVICES' OBJECTION TO LIFE INSURANCE EXEMPTIONS

Before the court are the objections filed by Farm Credit Services (FCS) to debtors' claims of exemption in two life insurance policies issued by State Farm Life Insurance Company.

A hearing was held in Mason City, Iowa on March 15, 1989. By order of this court, the record was reopened on June 14, 1989 and additional evidence was introduced. The court now issues the following ruling which will constitute findings of fact and conclusions of law pursuant to the requirements of Bankr. R. 7052. This is a core proceeding under 28 U.S.C. § 157(b)(2)(B).

FINDINGS OF FACT

The debtors are farmers who were indebted to Federal Land Bank of Omaha, now known as Farm Credit Services (FCS). Their debt to FCS was secured by a real estate mortgage on 160 acres. The debtors defaulted in their obligation to FCS in December, 1985 when they were able to pay only one-half of their interest payment plus principal. FCS initiated foreclosure proceedings in the Iowa District Court for Hancock County and on November 16, 1987, obtained a decree of foreclosure against the mortgaged property and a judgment against the debtors.

A receiver was appointed for the mortgaged premises for the 1987 crop year. The debtors rented the property from the receiver and fulfilled their rental obligation. During the 1987 crop year, the debtors also farmed 640 other acres, 160 of which were being purchased on a contract and the balance of which were being rented. During the period 1983 to 1988, the debtors farmed an additional 160 acres but ceased farming that during the referenced period. There is no indication as to the last year that this quarter section was farmed.

As a result of the foreclosure, a sheriff's sale was scheduled on the property for February 3, 1988. The debtors filed their chapter 11 bankruptcy case on February 1, 1988. The parties have stipulated and the court therefore finds that at all times relevant to the exemption issue, the sum of Smebys' debts exceeded the total value of their assets.

On January 20, 1988, the debtors met with Garry Miller of Clear Lake, Iowa, an insurance agent for State Farm Life Insurance Co. (STATE FARM). Prior to that time, the only life insurance owned by the couple or either of them was a life insurance policy issued by Northern Life Insurance Co. of Seattle, Washington. That policy was issued September 14, 1959. Its face value was \$5,000.00. FCS

originally had objected also to the claim of exemption in this policy but withdrew its objection at the hearing on March 15, 1989.

When they met with the State Farm representative on January 20, 1989, each of the debtors made application for the purchase of a life insurance policy. Linda J. Smeby made application to purchase a face value universal life policy in the amount of \$380,000.00. Byron Smeby made application to purchase a universal life insurance policy with a face value of \$260,000.00. The initial premium for each of the policies was \$70,000.00. The initial premium payments were made by check on January 20, 1988. The balance of the premium payments was made by check the next day, January 21, 1988. These policies were introduced into evidence as exhibits 4 and 2 respectively.

The debtors testified that they were told by the State Farm agent that the policies were effective upon the payment of the premium checks. Garry Miller testified that he believed the debtors had insurance on January 20, 1988, the date the policies were applied for.

The policies were not issued on January 20, 1988. Garry Miller testified that life insurance policies are not issued on the application date. He stated that he had no authority to issue an insurance policy on the application date since the application must be reviewed by the company prior to the issuance of a policy. The debtors did not receive possession of the policies until after the February 1, 1988 filing of their bankruptcy petition. Each of the policies carried a "policy date" of January 20, 1988. Each of the policies also bears the "issue date" of March 14, 1988. Each of the State Farm life insurance applications contain the following language on page 2:

Coverage will be effective as of the policy date, if the following conditions are met: The first premium is paid when the policy is delivered; the Proposed Insureds are all living on the delivery date; and, on that delivery date, the information given to State Farm Life is true and complete without material changes to the best of their knowledge and belief.

* * *

However, if a binding receipt has been given and in effect, its terms will apply.

All Proposed Insureds and the Applicant state that the information in this application and any medical history is true and complete to the best of their knowledge and belief. It is agreed that State Farm Life can investigate the truth and completeness of such information while the policy is contestable.

By accepting the policy, the Owner agrees to the beneficiaries named, method of payment and corrections made. No changes in plan, amount, benefits, or age at issue may be made on the application unless the Owner agrees in writing. Only an authorized company officer may change the policy provisions. Neither the agent nor a medical examiner may pass on insurability.

The cover page of the policy itself contained the following language:

10-Day Right to Examine the Policy. This policy may be returned within 10 days of its receipt for a refund of all premiums paid. Return may be made to State Farm Life Insurance Company or one of its agents. If returned, this policy will be void from the policy date.

Garry Miller gave each of the debtors a "Binding Receipt for Death Benefits" on January 20, 1988, the date of the life insurance policy applications. The binding receipt stated:

As of the application date, death benefits applied for take effect for death, subject to the terms of this Receipt. Death must result from an accident that occurs or an illness that first manifests itself after the application date. THE TOTAL DEATH BENEFIT FOR SOMEONE INSURED UNDER THIS OR ANY OTHER RECEIPTS AND APPLICATIONS WILL NOT EXCEED \$250,000. IF THAT INSURED IS UNDER THE AGE OF 15 DAYS AT DEATH, THE TOTAL DEATH BENEFIT WILL NOT EXCEED \$2,500.

Coverage under this Receipt will end when the first of the following occurs: (a) The application is approved. (b) Notice of disapproval of the application is given. (c) 60 days have expired starting with the application date.

State Farm Life reserves the absolute right to disapprove the application by (a) offering to issue a policy other than as applied for or (b) declining to issue a policy. The notice of disapproval will be given to the Proposed Insured 1 or to the Applicant, if other than that insured. The notice will be given either (a) in person to or (b) by mailing it to the last known address of that Proposed Insured or Applicant. If mailed, coverage will end upon mailing of that notice.

The money received will be refunded if (a) the policy is not accepted or (b) State Farm Life declines to issue a policy or (c) the 60 day period has expired.

The coverage provided for in the binding receipt was effective only if the check for the premium payment was honored and there were no material misrepresentations in the application.

Because of their financial difficulties, the debtors had discussed with their attorney, R. Fred Dumbaugh, how they could keep farming with their sons. Dumbaugh explained that the purchase of life insurance from non-exempt property was "legal." The debtors believed this at the time they purchased the policies, and further Mr. Smeby believed that the purchase of the policies and the subsequent filing of bankruptcy was the only way he could continue his farming operation with his sons.

The effort to protect the family farming operation was the rationale behind the type of insurance purchased and the amount. It was determined by the debtors to put into the life insurance \$140,000.00 in proceeds from the sealing of 1987 crops. Prior to purchasing the life insurance, however, the debtors paid off an operating loan to First State Bank of Manly. The debtors were indebted to the bank for loans for the 1987 crop season and Mr. Smeby believed that the bank had a lien on a 1987 crop.

When the debtors met with the State Farm agent, they did not make any calculations to determine whether they were making the most efficient purchase of life insurance for the dollars spent. Linda Smeby testified that they had a certain amount of money to put into life insurance. She further testified that the universal life policy was purchased because of the ability to borrow from the cash reserve and because no additional premiums would be required.

Since the filing of the bankruptcy case, the debtors have borrowed \$56,000.00 from State Farm on policy loans. A loan of \$36,000.00 was obtained in mid-April, 1988, and \$20,000.00 in May of 1988.

These funds were used to pay an adequate protection payment to FCS. FCS and the debtor had entered into an adequate protection agreement as a result of FCS's motion for relief from stay (Contested No. 68043). The balance was used to pay rent on other farm property.

Prior to and at the time of filing, the debtors owned approximately \$43,000.00 in livestock and \$50,000.00 worth of farm machinery and equipment. None of these assets were encumbered. The debtors have claimed \$20,000.00 of the machinery and equipment as exempt. None of the livestock has been claimed as exempt. Mr. Smeby testified he had not sold the livestock because it was necessary for the continuation of the farming operation.

DISCUSSION

I.

FCS filed its objection to the life insurance policies on March 10, 1988. The objection filed by FCS stated:

The objection to the life insurance exemption is made based upon information and belief of the Federal Land Bank of Omaha that all or a portion of the funds used to purchase the life insurance claimed exempt were funds in which the Federal Land Bank had an interest. This objection is also made upon the information and belief that the Debtors purchased all or a major portion of the life insurance claimed exempt for the sole purpose of hindering, delaying or defrauding their creditors.

The exemption for life insurance in Iowa at the time of the debtors' claim of exemption stated:

"A debtor who is a resident of this state may hold exempt from execution the following property:

6. Any unmaturing life insurance policy owned by the debtor, other than a credit life insurance contract."

Iowa Code § 627.6(6) (1987).1

FCS argues that the debtors did not have any life insurance contracts at the time of the filing of the bankruptcy and therefore the life insurance policies cannot be exempt. FCS argues that an application for insurance must be accepted by the proposed insurer before it can become a contract for insurance and thus no life insurance policies existed at the time of bankruptcy and the funds created by the deposits of the premiums is not exempt.

The debtors argue that the effective date of the insurance contract was January 20, 1988, which was the date the debtors applied for the insurance and paid the initial premiums. The debtors contend that there was a life insurance contract in effect on the day of filing which is exempt pursuant to Iowa Code § 627.6(6) (1987).

Generally, an application for life insurance is only an offer to buy insurance and the life insurance contract is not effective until the application has been accepted by the insurance company. Beyer v. Central Life Ins. Co., 199 Iowa 245, 201 N.W. 577, 578 (1925); Kimbrow v. New York Life Ins. Co., 134 Iowa 84, 108 N.W. 1025, 1027 (1906).

The language of the application states on page 2:

Coverage will be effective as of the policy date, if the following conditions are met: The first premium is paid when the policy is delivered; the Proposed Insureds are all living on the delivery date; and, on that delivery date, the information given to State Farm Life is true and complete without material changes to the best of their knowledge and belief.

The policy indicates that the policy date is January 20, 1988. The issue date for the policies was March 14, 1988. The policy date is defined as "the effective date of this policy." The effective date is the date coverage starts.

The State Farm agent, Garry Miller, testified that a binding receipt was given to the debtors at the time the applications were executed. A blank copy of a binding receipt was admitted into evidence as Exhibit 6. The binding receipt states in part:

As of the application date, death benefits applied for take effect for death, subject to the terms of this Receipt. Death must result from an accident that occurs or an illness that first manifests itself after the application date. THE TOTAL DEATH BENEFIT FOR SOMEONE INSURED UNDER THIS OR ANY OTHER RECEIPTS AND APPLICATIONS WILL NOT EXCEED \$250,000. IF THAT INSURED IS UNDER THE AGE OF 15 DAYS AT DEATH, THE TOTAL DEATH BENEFIT WILL NOT EXCEED \$2,500.

The initial premiums for the life insurance policies of both Byron and Linda Smeby were paid on January 20, 1988, the same date the life insurance applications were given to the State Farm agent. The proposed insureds were living on the delivery date, which was sometime after the issue date of March 14, 1988. There is no indication that the information given to State Farm was not true or complete.

The life insurance policies state that "if a binding receipt has been given and is in effect, its terms will apply." There is no evidence that the debtors' premium payments were dishonored or that the applications contained any material misrepresentations. There is sufficient evidence to conclude that Garry Miller had the authority to enter into a temporary insurance contract that would be effective as of the application date. The binding receipt created a valid insurance contract on January 20, 1986.

The Iowa Supreme Court stated in Nertney v. National Fire Ins. Co. of Hartford, Conn., 199 Iowa 1358, 203 N.W. 826, 828 (1925):

[W]hen it is shown that it is the custom of the company upon accepting the application to issue its policy covering the period from the date of the application, its agent taking the application has implied or apparent authority to make a valid preliminary contract of insurance effective from the making of the application until its acceptance or rejection.

See also Boever v. Great American Ins, Co., N.Y., 221 Iowa 566, 266 N.W. 276, 278 (1936).

The effective date of the debtors' policies was the application date. It appears that the company's custom was to issue the policy covering the period from the date of the application. Therefore, the agent had the authority to enter into a valid contract of insurance that would bind the company from the application date.

Since the debtors had death benefits as of January 20, 1986, the debtors possessed valid life insurance contracts on the date of the bankruptcy filing, which are eligible for exemption under Iowa Code § 627.6(6) (1987).

II.

The court has determined that there was a valid insurance contract on the day of the debtors' bankruptcy filing. Therefore, the court must address the issue of whether the life insurance exemption should be denied on grounds of conversion or denied because the policies were purchased by Smebys with intent to hinder, delay or defraud their creditors.

As to FCS's objection to the life insurance exemption on the grounds of conversion, the court finds and concludes that FCS has failed to meet its burden of proof imposed by Bankr. R. 4003(c). FCS has failed to show that the proceeds of crops in which it had a security interest were used to purchase the State Farm policies.

FCS also claims that the claim of exemption in the life insurance policy should be denied because the policies were purchased by Smebys with intent to hinder, delay or defraud their creditors. There is no doubt from the testimony that Smebys purchased the exempt policies in an effort to put some of their non-exempt assets out of the reach of creditors in order to continue their farming operation. This motive without more, however, should not deprive Smebys of the claimed exemption. Hanson v. First National Bank in Brookings (In re Hanson), 848 F.2d 866, 868 (8th Cir. 1988).

An extensive discussion of the law involving the fraudulent conversion of non-exempt property into exempt property was recently set forth in a decision written by the Honorable Michael J. Melloy. In re Krantz, 97 B.R. 514 (Bankr. N.D. Iowa 1989). The court in Krantz held that the objector to exemptions must prove fraud by clear and convincing evidence. Id. at 519.

[A] debtor's conversion of non-exempt property to exempt property on the eve of bankruptcy for the express purpose of placing that property beyond the reach of creditors, without more, will not deprive the debtor of the exemption to which he otherwise would be entitled. (Citations omitted.)

Hanson v. First National Bank in Brookings (In re Hanson), 848 F.2d 866, 868 (8th Cir. 1988). The objector to the exemption must provide sufficient evidence to indicate that the conversion of nonexempt property into exempt property was done with the actual intent to hinder, delay or defraud creditors.

The court must look at all the facts and circumstances in order to determine whether there is sufficient extrinsic evidence of fraud to warrant an inference of actual intent to hinder, delay or defraud creditors. The bankruptcy court for this district has used a listing of seven badges of fraud as the framework for analyzing the pertinent facts. Krantz at 523. These badges of fraud include the following:

- (1) Whether there was fair consideration paid for the life insurance policy;
- (2) Whether the [debtor] was solvent or insolvent as a result of the transfer or whether he was insolvent at the time of the transfer;
- (3) The amount of the policy;

(4) Whether the [debtor] intended, in good faith, to provide by moderate premiums some protection to those to whom he had a duty to support;

(5) The length of time between the purchasing of a life insurance policy and the filing of the bankruptcy;

(6) The amount of non-exempt property which the debtor had after purchasing the life insurance policy;

(7) The [debtor's] failure to produce available evidence and to testify with significant preciseness as to the pertinent details of his activities shortly before filing the bankruptcy petition.

Krantz at 523.

The court will analyze the above badges of fraud to determine if there is any extrinsic evidence of fraud.

1. Fair consideration. There is no dispute with regard to the existence of fair consideration.

2. Insolvency at the time the life insurance policies were purchased. The debtors at the hearing on March 15, 1989 stipulated to the existence of their insolvency at the time of their life insurance applications.

3. Amount of the policy. The life insurance policy purchased by Byron Smeby provides for death benefits in the amount of \$260,000.00. The life insurance policy purchased by Linda Smeby provides for a death benefit of \$380,000.00. The initial premium was \$70,000.00 for each policy. The cash value on the policy date is 92-1/2% of the initial premium less the monthly deduction for the first policy month. Therefore, the cash value on January 20, 1988 for each policy was \$64,750.00 less the monthly deduction for the first policy month. The Smebys have borrowed \$56,000.00 from State Farm in policy loans since the filing of the bankruptcy case. The debtors borrowed \$36,000.00 in mid-April, 1988 and \$20,000.00 in May, 1988. The funds were used to pay an adequate protection payment to Federal Land Bank of Omaha and the balance was used to pay rent on other farm property.

The amount of the claimed life insurance exemption was one of the key factors in the Krantz decision. Krantz at 524-26. In Krantz, the debtors sought to exempt life insurance with a cash value of \$539,548.00. The court in Krantz held that the debtors had converted non-exempt property into exempt property with the intent to hinder, delay or defraud creditors. Id. at 531.

The Eighth Circuit Court of Appeals has recently addressed the issue of whether the conversion of non-exempt property into exempt property was done with the intent to hinder, delay or defraud creditors. Hanson v. First National Bank in Brooking, 848 F.2d 866 (8th Cir. 1988); Norwest Bank Nebraska, N.A. v. Tveten, 848 F.2d 871 (8th Cir. 1988). In Tveten, the debtors sought a life insurance exemption of approximately \$700,000.00. The Eighth Circuit summarized its decision in Tveten as follows: "We hold that the bankruptcy court was not clearly erroneous in inferring fraudulent intent on the part of the debtor, rather than astute pre-bankruptcy planning, with respect to his transfers on the eve of bankruptcy which were intended to defraud, delay and hinder his creditors." Id. at 877. The court determined that the debtor's attempt to shield property worth approximately \$700,000.00 went beyond the purpose for which exemptions are intended.

In Hanson v. First National Bank in Brookings, 848 F.2d 866 (8th Cir. 1988) the court held that the bankruptcy court was not clearly erroneous in finding no fraudulent intent by the debtors in permitting them to claim their life insurance exemption. In Hanson, the debtors claimed as exempt life insurance policies with cash surrender values of \$9,977.00 and \$9,978.00. The debtors sold non-exempt property two days before filing the petition and used the proceeds to purchase the life insurance policies.

The Smebys have claimed as exempt life insurance policies with a total cash value of approximately \$129,500. Although this is a somewhat large amount, this court does not believe that the debtors purchased the life insurance policies with the intent to hinder, delay or defraud creditors. At the time of the debtors' bankruptcy filing, there was not a monetary limitation on the amount of life insurance that could be claimed exempt. The Iowa Supreme Court held in Westinghouse Credit Corp. v. Crotts, 250 Iowa 1273, 98 N.W.2d 843, 846 (1959) that the life insurance exemption statute "was enacted to grant liberal exemptions where needed and it must be liberally construed." The court also stated: "[T]he legislature intended to be definitely liberal in extending protection from their creditors to those who choose to protect themselves and their families by providing insurance against many of the possible vicissitudes of life." 98 N.W.2d at 845. The debtors testified that the life insurance was purchased in order to protect the family farming operation. The debtor was involved in the farming operation with his two sons. The debtor also testified that the insurance was necessary in order to protect him or his wife from accident or illness. The purposes for which the debtors purchased their life insurance policies fall in the category of what is considered a valid reason for claiming property as exempt.

4. Good faith. Farm Credit Services argues that the type of policy purchased by the debtors is an indication of the lack of good faith. FCS argues that the policy is a single premium universal life insurance policy in which a large deposit is made for the first premium. FCS argues that the debtors could have obtained a single premium policy with an initial payment of a fraction of that made, if the debtors had truly intended to provide for life insurance coverage.

Farm Credit Service also argues that the timing of the applications for the life insurance policies indicates a lack of good faith. The applications were made approximately twelve days prior to the filing of the chapter 11 case. Absent the conversion

of non-exempt assets into exempt life insurance, FCS argues that it could have obtained a large deficiency judgment with which it could have executed against part of the debtors' non-exempt assets.

The court does not believe that the debtors acted in bad faith in converting non-exempt assets into exempt life insurance. As previously indicated, the debtors purchased life insurance in order to allow them to continue farming and to provide for their sons.

There are five basic purposes for exemption laws:

1. To provide a debtor enough money to survive.
2. To protect his dignity and his cultural and religious identity.
3. To afford a means of financial rehabilitation.
4. To protect the family unit from impoverishment.
5. To spread the burden of the debtor's support from society to his creditors.

In re Hahn, 5 B.R. 242, 244 (Bankr. S.D. Iowa 1980) citing Resnich, 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, 621 (1978). The debtors' desire to continue farming in order to support their family falls within the described purposes for exemption laws.

The fact that the life insurance was purchased only a few days prior to the bankruptcy filing is not enough to conclude that the life insurance purchase was not in good faith. The court finds that the Smebys purchased the life insurance in good faith to provide protection for themselves and their family.

5. Length of time between purchase of life insurance and bankruptcy. The Smebys purchased the life insurance policies on January 20, 1988. The chapter 11 bankruptcy was filed on February 1, 1988. FCS argues that this short period of time between purchase of the life insurance policy and filing of the bankruptcy indicates that the applications for life insurance were obviously made for the sole purpose of protecting these cash deposits from the Farm Credit Bank. The short period of time between the filing of the bankruptcy petition and the purchase of life insurance contract does not favor the debtors. However, the fact that the life insurance was purchased immediately prior to filing of the bankruptcy is not without more enough to conclude that the life insurance was purchased with the intent to hinder, delay or defraud creditors.

6. Amount of non-exempt property remaining after the purchases of life insurance and retention of use.

The bankruptcy schedules filed by the debtors indicate the total value of their assets was \$966,669.00. Schedule B-4 indicates that the debtors claimed as exempt assets with a total value of \$171,895.00. After the purchase of the life insurance policies, the debtors had approximately \$794,774.00 in non-exempt property remaining. However, approximately \$670,000.00 of this property is subject to security interests. According to the schedules, the debtors had approximately \$125,000.00 in non-exempt and unencumbered property remaining after the purchase of the life insurance policies. The court finds that the amount of non-exempt property remaining after the purchase of life insurance fails to provide support for FCS's argument that the debtors converted non-exempt property into exempt property with intent to hinder, delay or defraud their creditors.

7. Debtors' ability to detail actions prior to filing bankruptcy and source of funds.

There does not appear to be any dispute that the funds used to purchase the life insurance were derived from the proceeds of the 1987 crops grown by the debtors. The evidence at trial established that FCS did not have a lien on the 1987 crop proceeds. The evidence also establishes that the debtors were able to detail their actions regarding the purchase of life insurance contracts prior to filing of the bankruptcy case.

The debtors have also raised the defense that the decision to purchase life insurance was based on the advice of their former counsel, R. Fred Dumbaugh. Debtor Byron Smeby testified that Dumbaugh said that the purchase of life insurance from non-exempt property was "legal." The evidence indicates that the Smebys were concerned about the legality of using non-exempt property to purchase exempt life insurance. The purchase of life insurance was not executed until they were assured by their counsel that it would be "legal".

A debtor who acts in reliance on the advice of his attorney generally lacks the required intent to defraud his creditors. Federal Land Bank of Omaha v. Ellingson (In re Ellingson), 63 B.R. 271, 276 (Bankr. N.D. Iowa 1986), citing In re Adeeb, 787 F.2d 1339, 1343 (9th Cir. 1986). The reliance on the advice of counsel, however, must be reasonable. Norwest Bank Nebraska, N.A. v. Tveten, 841

F.2d 871, 876 (8th Cir. 1988); In re Bateman, 646 F.2d 1220, 1224 (8th Cir. 1981). The court finds that the debtors' reliance on the advice of their attorney, R. Fred Dumbaugh, regarding the purchase of life insurance with non-exempt assets was reasonable.

After considering the seven badges of fraud and the reliance of counsel defense, the court finds that FCS has failed to prove by clear and convincing evidence that the debtors converted nonexempt property into exempt property with the intent to hinder, delay or defraud their creditors.

CONCLUSIONS OF LAW

1. Debtors, Byron Smeby and Linda Smeby, owned valid life insurance contracts on the date of the filing of their chapter 11 bankruptcy.
2. Farm Credit Service, the objector to the exemptions, has failed to prove that the debtors, Byron and Linda Smeby, purchased life insurance with the intent to hinder, delay or defraud their creditors.

ORDER

IT IS ORDERED that Farm Credit Services' objections to exemptions are overruled.

SO ORDERED THIS 22nd DAY OF JUNE, 1989.

William L. Edmonds
Bankruptcy Judge

¹ This subsection was amended by the Iowa Legislature in 1988. However, the amendment is inapplicable because it only applies to cases filed on or after May 15, 1988. A debtor's exemption rights are determined as of the date of the bankruptcy filing. See In re O'Brien, 67 B.R. 317, 319 (Bankr. N.D. Iowa 1986); In re Hahn, 5 B.R. 242, 245 (Bankr. S.D. Iowa 1980).