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Trustee Talk

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Law v. Siegel Dicta Leads Lower Courts Astray

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Editor's Note: *For another perspective on* Law v. Siegel *and the reach of § 105(a), read the feature article on p. 28 in the May 2014 issue.*

A pattern has emerged in the U.S. Supreme Court's bankruptcy exemption jurisprudence: The Court will clarify one important point of law, only to create confusion through its *dicta* on another. Its recent decision in *Law v. Siegel*[1] has proven to be no exception. In *Law v. Siegel*, the Court made a fairly straightforward holding that under § 522(k) of the Bankruptcy Code, a bankruptcy trustee cannot surcharge a legitimately claimed exemption to pay administrative expenses. The Court did not stop there, however; it suggested, in *dicta*, that bad faith and fraud are not a basis for disallowing an exemption.

In the ensuing months, lower courts have rendered decisions finding that bad faith and fraud are now, *per se*, no longer grounds for disallowing an exemption. Not only is that blanket conclusion not supported by the actual holding of *Law v. Siegel*, but it ignores a number of options that still exist for a trustee when addressing the claimed exemptions of a bad-faith or fraudulent debtor. This article will review a trilogy of Supreme Court exemption cases in which their *dicta* has led lower courts astray, along with the options that still exist for trustees when faced with a debtor's exemptions claimed fraudulently or in bad faith.

The Supreme Court and Exemptions

The Supreme Court has now, on three occasions, issued rulings in the context of bankruptcy exemptions in which the Court's *dicta* has confused the lower courts and debtors alike. In the first of these cases, *Taylor v. Freeland & Kronz*,[2] the Court addressed whether a trustee must timely object to an exemption that, on its face, is not allowable. In that case, the debtor had scheduled an employment-discrimination claim with both a value and asserted exemption of "unknown."[3] The Court determined that a timely objection to the exemption claim was required. Section 522(l) of the Bankruptcy Code provides that "unless a party in interest objects, the property claimed on (Schedule C) is exempt," and Fed. R. Bankr. P. 4003(b) gives parties-in-interest 30 days after the later of the initial meeting of creditors or an amendment to the schedules in which to object. Accordingly, the Court concluded that where there was no colorable basis for the exemption, parties must file a timely objection to it or it will be allowed.[4]

However, the Court went on to write in *dicta* that "[i]f [the trustee] did not know the value of the potential proceeds of the [asset], he could have sought a hearing on the issue ... or he could have asked the bankruptcy court for an extension of time to object."[5] Based on this language, courts and debtors concluded that where the scheduled value equals the claimed exemption — an "in-kind exemption" — the onus is on the trustee to timely object or else the asset would be deemed fully exempt and excluded from the bankruptcy estate. "In-kind exemptions" became common practice and required trustees to object to several thousand each year to protect bankruptcy estates.

In fact, the permissibility of "in-kind exemptions" continued for 18 years until 2010, when the Supreme Court clarified in *Schwab v. Reilly*[6] that such exemptions were not acceptable. In *Schwab*,

1 134 S. Ct. 1188 (2014).

2 503 U.S. 638 (1992).
3 *Id.* at 640.
4 *Id.* at 643-44.
5 *Id.* at 644.
6 130 S. Ct. 2652 (2010).

the debtor had valued her kitchen equipment and claimed an exemption in the same dollar amount (an "in-kind exemption").[7] The trustee did not object because the claimed exemption was proper. When the trustee sought to sell the equipment, the debtor objected on the basis that the entire asset had been removed from the estate after the deadline to object to exemptions passed.[8] The lower courts all ruled in the debtor's favor,[9] but the Supreme Court reversed, explaining that the Bankruptcy Code permits a debtor to exempt an interest in an asset stated in dollar terms, but not the asset itself, with only a few inapplicable exceptions.[10] In reaching this holding, the Court clarified that its earlier decision in *Taylor* merely stood for the proposition that an interested party must object to a claimed exemption *if* the amount that the debtor lists is not within the statutory limits or the asset is not subject to an exemption claim.[11] However, *Taylor* did not mean that a debtor who exempts the entire scheduled value of an asset is claiming the entire asset as exempt regardless of its true value.

While the Court clarified the uncertainty created by the dictum in *Taylor*, it did not stop there. Instead, the Court noted, in *dicta*, that the listing of an exemption as 100 percent fair-market value (FMV) or use of a similar declaration would alert the trustee of the need to object.[12] As a result, debtors began asserting 100 percent FMV-type exemptions, and only after extensive litigation in courts throughout the country did an overwhelming majority view emerge that such an exemption is actually contrary to the *Schwab* holding and impermissible,[13] and perhaps even sanctionable.[14] This pattern has continued with the Supreme Court's dictum in *Law v. Siegel*.

Law v. Siegel

In 2008, the trustee filed a surcharge motion, alleging that the debtor had created a fictitious and fraudulent second mortgage on his residence to falsely show that the property had no equity beyond its legitimate exemption and mortgage encumbrances in order to dissuade the trustee from attempting to sell the property.[15] The debtor had scheduled a second mortgage for $156,929 in favor of Lily Lin of China that he had forged.[16] The trustee sought the surcharge to pay some of the $450,000 in unfunded administrative expenses that he and his counsel incurred due to the debtor's refusal to cooperate and his appeal of more than a dozen bankruptcy court rulings.[17] The bankruptcy court granted the surcharge motion and ordered the debtor's entire $75,000 homestead exemption surcharged.[18] The Bankruptcy Appellate Panel (BAP) affirmed the surcharge in an unpublished opinion.[19]

In another unpublished opinion, the Ninth Circuit Court of Appeals affirmed the BAP's decision, explaining that "the surcharge was calculated to compensate the estate for the actual monetary cost imposed by the debtor's misconduct, and was warranted to protect the integrity of the bankruptcy process."[20] Thereafter, the First Circuit Court of Appeals, in an opinion authored by Justice David Souter sitting by designation, also upheld the appropriateness of surcharging exemptions.[21] Thus, the First and Ninth Circuits both permitted a surcharge of exemptions, while the Tenth Circuit did not,[22] thereby creating a division in the circuit courts that the Supreme Court agreed to resolve.[23]

> **Early reactions from the lower courts indicate that the Court's *dicta* ... will be broadly adopted without regard to applicable rules or legal doctrine.**

A unanimous Supreme Court reversed the Ninth Circuit on the basis that neither § 105(a) nor any inherent authority of the bankruptcy court could contravene a specific Code provision — § 522(k) — which expressly prohibited the application of a debtor's exempt property to the payment of any administrative expenses (excepting certain inapplicable situations).[24] Therefore, the Court explained that notwithstanding all of the debtor's misconduct and the prejudice suffered by the trustee, the bankruptcy court was without authority to surcharge the debtor's homestead exemption for the purpose of paying the trustee's administrative expenses.[25] The Court further noted that the bankruptcy court still retained the ability to sanction debtor misconduct through other means, including denial of discharge and imposing sanctions pursuant to Fed. R. Bankr. P. 9011 and the court's inherent authority and § 105, but that those powers could not be used to contravene an express Code provision.[26]

However, as was the case in both *Taylor v. Freeland & Kronz* and *Schwab v. Reilly*, the Court did not stop at that point. Rather, the Court suggested that bankruptcy courts lacked the authority to ever disallow an exemption based on a debtor's fraudulent concealment of an asset.[27] Given that the exemption claimed in *Law* was a legitimately claimed exemption, this discussion was clearly *dictum*. Nevertheless, its impact is already being seen in lower court decisions.

Decisions Since *Law v. Siegel*

In the time since the Supreme Court decided *Law*, courts have already seized on its *dicta* in disallowing exemptions based on bad faith and fraud. The district court's decision in *In re Baker*[28] is a prime example. In this case, the debtors filed a chapter 13 petition shortly after losing their home in foreclosure proceedings,[29] and the case was subsequently converted to chapter 7. At no point during the bankruptcy

7 *Id.* at 2657.
8 *Id.* at 2658.
9 *Id.* at 2659.
10 *Id.* at 2661-62.
11 *Id.* at 2665-66.
12 *Id.* at 2668.
13 *See, e.g., In re Massey*, 465 B.R. 720 (B.A.P. 1st Cir. 2012).
14 *See In re Gregory*, 487 B.R. 444 (Bankr. E.D.N.C. 2013).
15 *Law*, 134 S. Ct. at 1193.
16 *Id.*
17 *Id.* at 1194.
18 *Id.*
19 *See* 2009 WL 7751415 (B.A.P. 9th Cir. 2009).
20 *In re Law*, 435 Fed. App'x. 697, 698 (2011) (*per curiam*).
21 *Malley v. Agin*, 693 F.3d 28 (1st Cir. 2012).
22 *See In re Scrivner*, 535 F.3d 1258 (10th Cir. 2008).
23 *Stephen Law v. Alfred H. Siegel, Chapter 7 Trustee*, 435 Fed. App'x. 697 (9th Cir. 2011), *cert. granted* June 17, 2013.
24 *Law*, 134 S. Ct. at 1195.
25 *Id.*
26 *Id.* at 1198.
27 *Id.* at 1196-97.
28 514 B.R. 860 (E.D. Mich. 2014).
29 *Id.* at 860, 862.

proceedings did the debtors list any legal claims relating to the foreclosure sale.[30] However, after receiving their discharge and the closure of their case, the debtors filed wrongful foreclosure actions without reopening their bankruptcy case to report the claims.[31] Upon learning of the claims several years later, the trustee had the bankruptcy case reopened. The debtors then amended their schedules to report the claims to be worth $3 million and claimed wild-card exemptions of $5,300 in each.[32] The trustee objected to the claimed exemptions on bad-faith and inequitable-conduct grounds.[33]

In the meantime, the trustee negotiated a settlement of the wrongful foreclosure claims, which was approved by the bankruptcy court.[34] The bankruptcy court overruled the trustee's objections to the debtors' exemptions based on *Law*. The trustee appealed, but the district court affirmed based on *Law*.[35]

The bankruptcy court reached a similar result in *In re Arellano*.[36] In this case, the trustee determined at the meeting of creditors that the debtor had an unscheduled bank balance of $4,958.65 and an anticipated tax refund of $2,000.[37] The debtor proceeded to amend his Schedules B and C to list the omitted assets and claim them as exempt,[38] but the trustee objected. The court overruled the objection, noting that the Ninth Circuit precedent that authorized bankruptcy courts to deny leave to amend or to disallow a claimed exemption on the basis of bad faith or creditor prejudice was abrogated by *Law*. The court concluded that "the bankruptcy court's equitable powers are now an insufficient basis for exemption denial even if bad faith or prejudice exists."[39]

Most recently, in *Gray v. Warfield (In re Gray)*,[40] the Ninth Circuit BAP relied on *Law* in reversing a bankruptcy court's order sustaining a trustee's objection to an amended exemption on the grounds of bad faith, where the debtors' initial schedules did not list prepaid rent as an asset or claim. After the trustee learned that the debtors had prepaid rent before the bankruptcy filing and demanded its turnover, the debtors amended their schedules to list the rent and claim it as exempt.[41] The trustee objected, and the bankruptcy court sustained the objection on the basis that the debtors acted in bad faith and intentionally concealed the prepaid rent.[42] The BAP reversed, explaining that *Law* "mandates the conclusion that the bankruptcy court is without federal authority to disallow the Amended Exemption or to deny leave to amend exemptions based on [the] Debtors' bad faith."[43] The BAP reached this conclusion notwithstanding its explicit recognition that the Supreme Court's discussion on this point was non-binding *dicta*.[44]

Trustee Options in the Wake of *Law v. Siegel*

Notwithstanding these initial decisions interpreting *Law v. Siegel*, bankruptcy trustees still have viable options in combatting fraudulently claimed exemptions. As an initial matter, *Law* is directly applicable only to cases in which a trustee seeks a surcharge of a *legitimately* claimed exemption. While the case involved a debtor who engaged in fraud, the claim of a $75,000 homestead exemption was indisputably legitimate. Accordingly, its holding should not be applied in cases involving fraudulently claimed exemptions, as was done in *Baker*, *Arellano* and *Gray*.

Moreover, while courts have been quick to recognize a debtor's ability to freely amend claims of exemption as set forth in Fed. R. Bankr. P. 1009(a), courts have generally overlooked Fed. R. Bankr. P. 4003(b)(2), which specifically provides that "[t]he trustee may file an objection to a claim of exemption at any time prior to one year after the closing of the case if the debtor fraudulently asserted the claim of exemption." The effective date of this rule was subsequent to the petition date in *Law* and *Baker* and was not argued by the trustee in either case. While it might not be entirely useful in a case such as *Arellano* or *Gray* — where the omissions may not have risen to the level of fraud — Fed. R. Bankr. P. 4003(b)(2) does provide clear authority for a trustee to object to fraudulently asserted claims of exemption.

Another arrow in the trustee's quiver is the specific equitable powers of the federal courts, such as the imposition of judicial estoppel.[45] This is different than the court's general equitable powers, which were limited in the *dicta* in *Law v. Siegel*. To the extent that debtors take positions in their schedules (which are sworn statements), they can be estopped from adopting contrary subsequent positions. This can be yet another mechanism to prevent an abuse of process and the assertion of illegitimate claims of exemption. Finally, while *Law v. Siegel*'s holding does limit the ability of bankruptcy courts to surcharge a debtor's legitimately claimed exemption to pay administrative expenses or pre-petition debts, there are two notable exceptions: exemptions are still inapplicable against both domestic-support-obligation claims and tax liens.[46]

Conclusion

In *Law v. Siegel*, the Supreme Court has again addressed one area of uncertainty while simultaneously creating another. Early reactions from the lower courts indicate that the Court's *dicta* — that bad faith and fraud are no longer a basis for disallowing an exemption — will be broadly adopted without regard to applicable rules or legal doctrine. While history suggests that this confusion may continue until the Supreme Court's next decision in this area, it is important to recognize that trustees are not entirely without options in combatting fraudulently claimed exemptions. abi

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30 *Id.*
31 *Id.*
32 *Id.*
33 *Id.*
34 *Id.*
35 *Id.*
36 517 B.R. 228 (Bankr. S.D. Cal. 2014).
37 *Id.* at 228, 229.
38 *Id.*
39 *Id.* at 232.
40 2014 Bankr. LEXIS 4974 (B.A.P. 9th Cir. Dec. 9, 2014).
41 *Id.* at *1-2.
42 *Id.* at *3-4.
43 *Id.* at *9.
44 *Id.* at *7.

45 The Supreme Court has explained that the Bankruptcy Code does not overturn long-held pre-Code practices absent clear language to the contrary. *See Dewsnup v. Timm*, 502 U.S. 410 (1992). Equitable doctrines such as judicial estoppel would clearly fall into that category.
46 *See* 11 U.S.C. § 522(c)(3).