8

SUPREME COURT

The Supreme Court recently heard a number of bankruptcy cases, including two cases specifically involving consumer debtors. In *Law v. Siegel*, the Court addressed the issue of whether a bankruptcy court has the power under § 105(a) to surcharge a debtor's exemptions when a debtor has acted in bad faith. "*Law v. Siegel*: U.S. Supreme Court Limits Reach of § 105(a)" provides a cogent analysis of the Court's unanimous decision and its impact on trustees and bankruptcy judges. In *Bullock v. BankChampaign NA,* the Court addressed the question of whether a "culpable state of mind" was needed to meet the "defalcation" exception to discharge set forth in § 523(a)(4) of the Bankruptcy Code. The Court unanimously held that "where the conduct at issue does not involve bad faith, moral turpitude, or other immoral conduct, the term requires an intentional wrong." "The Effects of *Bullock* on Nondischargeability Proceedings" sets forth a an analysis of the practical implications of *Bullock*, and concludes that this opinion will likely be the "first and last word" from the Supreme Court on defenses to nondischargeability actions.

A. *Law v. Siegel*: U.S. Supreme Court Limits Reach of § 105(a)

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Can a bankruptcy court invoke § 105(a) of the Bankruptcy Code to permit a trustee to surcharge property a debtor claims as exempt due to the debtor's extreme bad faith, notwithstanding express language in the Code to the contrary? The U.S. Supreme Court recently answered this question with a clear "no." In *Law v. Siegel*,[1] the Court ruled that § 105 cannot override a specific provision in the Bankruptcy Code, including the Code's exemption scheme. The Supreme Court's ruling reaffirms the well-settled proposition that bankruptcy courts' equitable powers are largely cabined by the four walls of the Bankruptcy Code. Nevertheless, the Court's decision may provide guidance to lower courts seeking to fashion practical remedies to bad-faith conduct.

Background

In 2004, Stephen Law, the petitioner, filed a chapter 7 case in the U.S. Bankruptcy Court for the Central District of California, and the respondent, Alfred Siegel, was appointed to serve as trustee. Law included on his schedule of real property holdings a house in California, which he valued at around $360,000. He claimed that $75,000 of the value was covered by California's homestead exemption, and he asserted that the house was encumbered by two voluntary liens in the amount of approximately $150,000 each, one held by Washington Mutual Bank and the other held by "Lin's Mortgage & Associates." Law represented that there was no equity in the house for the estate because the lien amount together with his exemption exceeded the house's value.

1 134 S. Ct. 1188 (2014). ABI hosted a media teleconference on March 11 with bankruptcy experts discussing this case. The recording is available at news.abi.org/educatonal-brief/bankruptcy-experts-discuss-supreme-courts-ruling-in-law-v-siegel.

The trustee brought an adversary proceeding alleging that the note and deed of trust by "Lin's Mortgage & Associates" was fraudulent. Two persons named "Lili Lin" appeared in the action. One, a California resident, stipulated that she had no interest in the house, denied ever loaning Law money and claimed that Law had repeatedly attempted to involve her in sham transactions. The second, supposedly a resident of China, stated that she held the note and deed of trust. The second "Lili Lin" vigorously litigated in the case, appealing the avoidance of the lien and the sale of the house.

Siegel subsequently moved to surcharge the $75,000 homestead exemption that was claimed by Law and sought to use exempt assets to cover his attorneys' fees in the litigation, which exceeded $500,000. The bankruptcy court granted the motion, finding that the lien supposedly held by Lili Lin was "fiction" and that Law had perpetrated a fraud on the court.[2] The court found that the appearance of "Lili Lin" was a "sham," and that it was "most plausible" that Law himself had prepared and signed the papers.[3] The Ninth Circuit Bankruptcy Appellate Panel upheld the bankruptcy court's factual findings and ruled that the bankruptcy court had not abused its discretion in surcharging the exempt assets.[4] The court relied on its precedent in *Latman v. Burdette*,[5] which provided that bankruptcy courts may equitably surcharge a debtor's statutory exemptions in "exceptional circumstances," such as when the "debtor engages in inequitable or fraudulent conduct that when left unchallenged, denies creditors access to property in excess of that which is properly exempted under the Bankruptcy Code."[6] The Ninth Circuit affirmed,[7] and the Supreme Court granted *certiorari*.

Supreme Court's Decision

In a unanimous decision authored by Justice Antonin Scalia, the Supreme Court reversed, holding that the bankruptcy court exceeded its authority in surcharging the exempt assets.[8] The Court's starting point was § 105(a) of the

2 *See In re Law*, 401 B.R. 447, 453 (Bankr. C.D. Cal. 2009).
3 *Id*. at 452-55.
4 *See In re Law*, No. 09-1077, 2009 WL 7751415 at *8-9 (B.A.P. 9th Cir. Oct. 22, 2009).
5 366 F.3d 774 (9th Cir. 2004).
6 *See In re Law*, 2009 WL 7751415 at *5, *7.
7 *See In re Law*, 435 Fed. Appx. 697 (2011) (*per curiam*).
8 *See Siegel*, 134 S. Ct. 1198.

Bankruptcy Code, which provides that bankruptcy courts may "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of" the Bankruptcy Code.[9] Citing its holding in *Marrama v. Citizens Bank of Mass.*,[10] the Court recognized that § 105 conferred on bankruptcy courts "inherent power ... to sanction 'abusive litigation practices'" under § 105(a). In exercising such power, the Court advised, bankruptcy courts cannot contravene specific provisions of the Code.[11] This is a principle that followed from the statutory construction rule providing that specific prohibitions limit general authority to take action.[12] This rule held steadfast for bankruptcy courts' § 105 and equitable powers, which "must and can only be exercised within the confines of" the Code.[13]

The Court ruled that the bankruptcy court's surcharge of exempt assets was unauthorized because it contravened § 522 of the Bankruptcy Code.[14] Section 522 provides that a chapter 7 debtor may exempt certain kinds of property from the bankruptcy estate, which, with limited exceptions, means that pre-petition debt or administrative expenses may not be paid from such property.[15] Section 522(b) permits the debtor to claim exemptions that are available under applicable state or local law, including "homestead" exemptions for the debtor's residence.[16]

Turning to the issue before it, the Court recognized that § 522(k), making applicable the $75,000 homestead exemption under California law, provided that the allegedly exempt assets were "not liable for payment of any administrative expense."[17] Such administrative expenses "indubitably" included the attorneys' fees that Siegel sought were under §§ 503(b), 330 and 327 of the Bankruptcy Code.[18] Hence, the Court proclaimed, the bankruptcy court's surcharge of the exempt assets to defray such fees exceeded its statutory authority under § 105(a).[19]

9 *Id*. at 1194.
10 549 U.S. 365, 375-76 (2007).
11 *See Siegel*, 134 S. Ct. 1194 (citing 2 *Collier on Bankruptcy* ¶ 105.01[2] (16th ed. 2013)).
12 *Id*. (citing *Morton v. Mancari*, 417 U.S. 535, 550-51 (1974)).
13 *See Siegel*, S. Ct. at 1194-95 (citing *Norwest Bank Washington v. Ahlers*, 485 U.S. 197, 206 (1988)).
14 *See Siegel*, S. Ct. at 1195.
15 *See* 11 U.S.C. § 522(c) and (k) (2010).
16 *See* 11 U.S.C. § 522(b)(3)(A) (2010).
17 *See Siegel*, 134 S. Ct. at 1195 (quoting 11 U.S.C. § 522(k)).
18 *Id*.
19 *Id*.

In papers before the Court, Siegel had argued that § 522 does not vest debtors with an absolute right to exemptions. Not so, the Court concluded. Rather, the Court reasoned, § 522 provides that debtors "may exempt" assets, and hence must be construed to place discretion with debtors, not the courts. In other words, if a debtor claims an exemption, a court may not deny the exemption absent specific statutory grounds to do so.[20]

Siegel had also argued to the Court that the surcharge did not violate § 522 because § 522 set forth a procedure by which debtors could claim exemptions, but it did not prohibit courts from surcharging or denying such exemptions.[21] The Court rejected this argument as well, recognizing that § 522 did not confer on bankruptcy courts power to grant or deny exemptions "based on whatever considerations they deem appropriate."[22]

The § 522 exemption scheme already included exceptions and limitations relating to the debtor's fraud, including denying the debtor's homestead exemption where the debtor had purchased the property with fraudulent intentions.[23] This "meticulous — not to say mind-numbingly detailed" exemption scheme made it clear that courts are not empowered to create additional exceptions.[24] The Court also found inapposite cases cited by Siegel for the proposition that courts may disallow exemptions when a debtor has fraudulently concealed allegedly exempt assets, finding that those cases relied on state law exceptions that were not applicable to the current case.[25]

The Court next turned to its prior decision in *Marrama v. Citizens Bank of Mass.*, a case that Siegel relied on his papers. In *Marrama*, the Court ruled that § 105 may be exercised to deny a debtor's right provided in the Bankruptcy Code to convert a bankruptcy case under chapter 7 to a chapter 13 case due to the debtor's bad-faith conduct.[26] The Court distinguished *Marrama*: In this case, the lower court's refusal to permit conversion did not violate the Code because § 706(a), which provided a debtor with the right to convert, was "expressly conditioned" on the debtor's ability to qualify as a chapter 13 debtor.[27]

20 *Id*. at 1196.
21 *Id*. at 1195-96.
22 *Id*.
23 *Id*.
24 *Id*.
25 *Id*. at 1196-97.
26 *Id*. at 1197 (citing *Marrama*, 549 B.R. 365, 372 (2007)).
27 *See Siegel*, 134 S. Ct. at 1195.

A debtor who had bad faith could not qualify as a chapter 13 debtor because § 1307(c) provided that a chapter 13 case could be dismissed "for cause," including a debtor's bad faith. Because the debtor's case, once converted, could at that time be dismissed "for cause," the *Marrama* debtor did not qualify for chapter 13 relief. The Court recognized that it had stated in "*dictum*" that refusal to convert a case was authorized under § 105(a) and might have been authorized by the court's inherent powers.[28] However, the court stated that this *dictum* could be stretched only to mean that "in some circumstances a bankruptcy court may be authorized to dispense with futile procedural niceties in order to reach more expeditiously an end result required by the Code."[29] According to the Court, it did not authorize bankruptcy courts to end-run express provisions of the Bankruptcy Code.[30]

The Court acknowledged that its decision "forces Siegel to shoulder a heavy financial burden resulting from Law's egregious misconduct," and that it may create inequitable outcomes for trustees and creditors in other cases.[31] However, it noted that bankruptcy courts have ample authority to respond to debtor misconduct through other statutorily permitted channels, such as ordering monetary sanctions or denying a discharge.[32] Such power can be derived from Federal Rule of Bankruptcy Procedure 9011, the bankruptcy counterpart to Federal Rule of Civil Procedure 11, which empowers a court to issue sanctions for litigation actions taken in bad faith. Notably, it stated that courts may have further powers to order sanctions "under either § 105(a) or its inherent powers."[33]

Discussion

As an initial matter, bankruptcy trustees assessing the impact of *Siegel* should bear in mind that they may have a priority claim to property that is allegedly subject to a homestead exemption to the extent that they avoid an interest in the property superior to the exemption under applicable state law.[34] In addition,

28 *Id*. (citing *Marrama*, 549 B.R. at 375-76).
29 *Siegel*, 134 S. Ct. at 1197.
30 *Id*.
31 *Id*.
32 *Id*.
33 *Id*. at 1198 (citing *Chambers v. NASCO Inc.*, 501 U.S. 32, 45-49 (1991)).
34 *See In re Swift*, 458 B.R. 8 (Bankr. D. Mass. 2011) (ruling that trustee that avoided equitable claim of mortgage-holder to have mortgage reinstated had interest in mortgage property superior to debtor's homestead exemption rights).

the *Siegel* decision makes it clear that bankruptcy courts may not exercise their powers under § 105(a) and inherent equitable authority in contravention of a specific provision in an intricate statutory scheme in the Bankruptcy Code. This reading is in line with the Court's decision in *RadLAX Gateway Hotel LLC v. Amalgamated Bank*,[35] in which the Court adopted a common-sense reading of Bankruptcy Code provisions governing cramdown reorganization plans.[36] *Siegel* also clarifies that the application of § 105(a) in the Supreme Court's *Marrama* decision was in line with the applicable statutory provisions in that case.

In holding that orders issued under § 105 may not conflict with specific statutory provisions of the Bankruptcy Code, *Siegel* reaffirms a well-settled proposition. Nevertheless, the Supreme Court recognized that a bankruptcy court may possess authority to sanction bad-faith litigation conduct beyond specific Bankruptcy Code and Rule provisions "under either § 105(a) *or its inherent powers*."[37] Lower courts may rely on the Court's statement to craft "meaningful" sanctions for bad-faith litigation based on case law precedent.[38] Bankruptcy practitioners will no doubt eagerly await further guidance from the Court on the specific contours of such inherent sanctioning authority.

35 132 S. Ct. 2065 (2012).
36 *Id*. at 2070-71.
37 *See Siegel*, 134 S. Ct. at 1198 (citing *Chambers v. NASCO Inc.*, 501 U.S. 32, 45-49 (1991) (emphasis added)).
38 *See Siegel*, 134 S. Ct. at 1198.

B. The Effects of *Bullock* on Nondischargeability Proceedings

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The U.S. Supreme Court in recent years has issued rulings on various bankruptcy topics, but few, if any, will have as much impact as the May 2013 decision of *Bullock v. BankChampaign NA*[1] has had and will continue to have on the defense of adversary proceedings in consumer bankruptcy cases. Unlike prior Supreme Court decisions in cases such as *Hamilton v. Lanning*, *Schwab v. Reilly* and *Ransom v. FIA Card Services NA*,[2] the *Bullock* decision is one that concentrates on the statutory text addressing the nondischargeability of debts.

More than 50 bankruptcy cases and a number of cases from the district courts have already cited *Bullock* in decisions, most of which involve adversary proceedings for nondischargeability under 11 U.S.C. § 523(a)(4). Debtors' counsel and firms specializing in adversary defense should be aware of these cases, the significance of the *Bullock* decision, and prior holdings in their district courts and/or courts of appeal to determine the rights of debtors currently in litigation and those who face potential litigation. This article focuses more on the practical implications of the *Bullock* decision for adversary defense and less on the case's procedural history by posing four questions that one should ask in order to gauge the decision's breadth, significance and the changing implications in § 523(a) adversaries.

1 133 S. Ct. 1754 (2013).
2 130 S. Ct. 2464 (2010); 130 S. Ct. 2652 (2010); 131 S. Ct. 716 (2011).

The Four Questions

What If the Bankruptcy Court Has Issued a Judgment in the Creditor's Favor, but Applied an Incorrect Standard to the Debtor/Defendant's Conduct?

The standard for "defalcation" under 11 U.S.C. § 523(a)(4) prior to the *Bullock* decision varied by region and by court. For instance, the Seventh Circuit Court of Appeals in *Matter of Thomas* issued an opinion in 1984 in which the basis of a nondischargeability claim was a state statute addressing contractors for public works.[3] Based on the *Thomas* decision, courts within the jurisdiction of the Seventh Circuit began applying "a per se approach to violations of the state theft by contract statute, without regard to any precise lack of care exercised by the debtor."[4] However, in *In re Berman*, the Seventh Circuit clarified a few years ago that "defalcation requires something more than negligence or mistake, but less than fraud."[5] Prior to *Bullock*, strict liability decisions could be reconciled, however tenuously, with the *Berman* standard. Since May, however, judges in the Seventh Circuit-governed bankruptcy courts have indicated a trend toward requiring an elevated showing under *Bullock* and have denied summary judgment on what previously would have been granted at summary judgment.[6]

In the best possible situation for a defendant debtor, the appellate court would acknowledge the reversal of prior controlling case law and remand to the district court for new findings, which is exactly what happened in one case from the Bankruptcy Appellate Panel (BAP) of the Tenth Circuit. In that case, the debtor was held to have committed a defalcation in a fiduciary relationship.[7] The bankruptcy court followed the guiding law at the time, *In re Storie*.[8] The *Storie* ruling stated that there was in fact no mental culpability on the part of the debtor fiduciary that was required to be shown.[9] On appeal, the BAP, citing *Bullock* — which was decided after the bankruptcy court's decision — aptly noted, "Most judges are right until they are wrong."[10] The case was remanded.

3 729 F.2d 502 (7th Cir. 1984).
4 *In re DiPietrantonio*, 12-33921, 2013 WL 5935153 (Bankr. E.D. Wis. Nov. 5, 2013).
5 629 F.3d 761, 765 n.3 (7th Cir. 2011).
6 *In re Vieaux*, 12-36663, 2013 WL 5935156 (Bankr. E.D. Wis. Nov. 5, 2013).
7 *In re Karch*, 499 B.R. 903, 905 (B.A.P. 10th Cir. 2013).
8 216 B.R. 283 (B.A.P. 10th Cir. 1997).
9 *Karch*, 499 B.R. at 906.
10 *Id*. at 904.

If the trial court has rendered a decision using an incorrect standard, and an appeal (or a motion for relief from judgment under Fed. R. Bankr. P. 9024) is still a timely option, this could be an effective way to obtain a ruling buttressing *Bullock* and providing clarity to the bankruptcy court. But beware: The incorrect standard alone might not be enough to warrant a reversal and remand to the bankruptcy court. Some courts might find enough facts in the record to still find a defalcation. For instance, one court found the acts of a defendant construction partner's actions in inflating expenses, co-mingling business funds in a personal account and failing to account for approximately $145,000 to be a defalcation under the *Bullock* standard.[11] In similar cases, the appellate court might agree that the standard applied was incorrect and might even remand to the bankruptcy court, but the debtor could still end up losing and incur higher costs in the process. There are occasions when the analysis, even with a heightened requirement for plaintiffs to provide proof, will still be met.

What If a Lawsuit Has Been Filed Against My Debtor and We Are at the Pre-Summary Judgment Stage of the Litigation?

While the *Bullock* decision might give creditors pause before they elect to pursue a nondischargeability claim, the success of creditors in obtaining judgments and the believed need to keep debtors honest by bringing these claims suggest that these actions will still continue. The first step upon receipt of a complaint is to review it to ensure that it states a claim under one or more of the nondischargeability subsections. If it does not, a motion to dismiss should be filed.[12] The entire exercise of litigation might not be necessary.

If the proceeding is brought in part or in whole under § 523(a)(4), the plaintiff has the burden of proving not only that there was a "fraud or defalcation" from which the debt arose, but that the predicate actions occurred while the debtor was acting in a fiduciary capacity.[13] The fiduciary duty is one determined under federal law,[14] so a state court judgment that finds a fiduciary duty might not be dispositive.[15]

11 *Adas v. Rutkowski*, 13 C 2517, 2013 WL 6865417 (Bankr. N.D. Ill. Dec. 30, 2013), at *9.

12 *See Bell Atlantic Corp. v. Twombly*, 127 S. Ct. 1955 (2007); *Ashcroft v. Iqbal*, 129 S. Ct. 1937 (2009).

13 *Cincinnati Ins. Co. v. Chidester*, 5:13cv063, 2013 WL 4539103 (W.D. Va. Aug. 27, 2013), at *3 (citing *Kubota Tractor Corp. v. Strack (In re Strack)*, 524 F.3d 493, 497 (4th Cir. 2008)).

14 *Catrambone v. Adams*, 498 B.R. 839, 847 (N.D. Ill. 2013).

15 *Id*. at 847-48.

Discovery will be critical as well, since it will establish what the plaintiff can prove circumstantially and by way of testimony and documents in order to convince the judge of the debtor's mental state at the time of the act(s). Under the *Bullock* standard, "where the conduct at issue does not involve bad faith, moral turpitude, or other immoral conduct, the term ['defalcation'] requires an intentional wrong."[16] A debtor acts with the requisite state of mind when he/she acts with "knowledge of, or gross recklessness in respect to, the improper nature of the relevant fiduciary behavior."[17]

As one court accurately noted, in light of the standard set by the Supreme Court in *Bullock*, a "[d]ebtor's credibility is highly relevant to [a] § 523(a)(4) nondischargeability claim."[18] "In weighing the credibility of witnesses, the Court must examine the evidence presented and evaluate the testimony, including variations in demeanor, as well as changes in the tone of voice."[19] The initial client meetings, 341 meeting, and depositions or Rule 2004 examinations will allow the attorney to gauge the client's trustworthiness in advance of a trial. Although cases under § 523(a)(4) will naturally turn on individual facts, opponents will have incrementally more post-*Bullock* summary-judgment or final-decision rulings to review and cite on motions for summary judgment.

What Happens if an Action Is Brought under Another Subsection of 11 U.S.C. § 523(a)?

Commentators pre- and post-*Bullock* have both speculated on how the Supreme Court's decision would impact other provisions of § 523(a).[20] One section that almost certainly will not be affected is the allegation of embezzlement under § 523(a)(4). Embezzlement is nondischargeable under this subsection whether or not it is committed by someone acting in a fiduciary capacity, because unlike defalcation, it requires a conversion.[21] In cases involving larceny or embezzlement, the *Bullock* decision makes it clear that the standard remains "felonious

16 *Bullock*, 133 S. Ct. at 1759.
17 *Id*. at 1757.
18 *In re Shao Ke*, 09-32272, 2013 WL 4170250 (Bankr. N.D.N.Y. Aug. 14, 2013), at *13.
19 *Hamdorf v. Gritton (In re Gritton)*, 2003 WL 1395566 at *4 (Bankr. N.D. Iowa March 13, 2003) (citing *Anderson v. City of Bessemer*, 470 U.S. 564, 575 (1985)).
20 Keith Murphy and Ferve Ozturk, "Deciphering Defalcation: *Bullock v. BankChampaign NA*," XXXII *ABI Journal* 4, 42-43, 104-05, May 2013.
21 *In re Pemstein*, 492 B.R. 274, 282 (B.A.P. 9th Cir. 2013).

intent" to deprive another of his/her property.[22] Thus, the other claims arising under § 523(a)(4) remain unchanged.

The other subsection requiring a *mens rea* element is § 523(a)(2): a debt "for money, property, services, or an extension, renewal, or refinancing of credit, to the extent is obtained by — false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition."[23] An adversary proceeding arising under this subsection would require the plaintiff's creditors to show that the debtor(s) had "the intent to deceive the plaintiffs in reference to the actual state of things, and to induce them to do what [the] defendants knew they would not otherwise have done, or been asked to do."[24] As the remaining actions to deny discharge of a debt arise from specific conduct or strict liability, instead of a particular intent, they need not be discussed further.

How Much Clarity Does the Bullock Decision Provide to Attorneys and Judges?

Judging by recent opinions, there is very little room left for interpretation as to the new standard. Trial courts are applying the correct standard at the summary-judgment stage,[25] after trial[26] and on appeal.[27] As of the submission of this article in late January 2014, there has been no appeal indicating that any court post-*Bullock* had used the improper standard or attempted to distinguish it in an adversary proceeding under § 523(a)(4).

Conclusion

In light of the detailed analysis in Justice Stephen Breyer's unanimous opinion, it is likely that this will be the first and last word from the Supreme Court on § 523. Unlike the Court's opinion in *Stern v. Marshall*,[28] the Court's direc-

22 *Bullock*, 133 S. Ct. at 1760 (cited by Stephen W. Sather, "*Bullock* and the Requirement of *Scienter* in Dischargeability Actions," XXXII *ABI Journal* 8, 16-17, 83, September 2013).
23 11 U.S.C. § 523(a)(2).
24 *Strang v. Bradner*, 114 U.S. 555, 560 (1885).
25 *In re Fitzgerald*, 11-33423, 2013 WL 4853316 (Bankr. N.D. Ohio Sept. 11, 2013).
26 *In re Colson*, 09-51954, 2013 WL 5352638 (Bankr. S.D. Miss. Sept. 23, 2013).
27 *In re Kurtz*, 12-07175 , 2013 WL 3467105 (C.D. Cal. July 10, 2013).
28 131 S. Ct. 2594 (2011).

tion ought not to cause additional litigation to clarify the extent of the holding or restrict the holding to specific instances. If the *scienter* requirement in *Bullock* is more stringent than the previous law in effect, one can expect the appellate court or even the trial court on reconsideration[29] to make a determination under the proper standard.

29 *In re Akbari-Shahmirzadi*, 7-11-15351, 2013 WL 3300056 (Bankr. D.N.M. July 1, 2013), at *5-6.