Concurrent Session

Exemptions: Sorting Through the Mess!

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2010 Educational Materials

Exemptions

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Supreme Court Weighs In on Exemptions: *Schwab v. Reilly*

Maria Gotsis, Esq.

On June 17, 2010, the United States Supreme Court ruled (6-3) in favor of the Trustee in *Schwab v. Reilly,* 130 S.Ct. 2652 (June 17, 2010). The Court held that a trustee is not required to object to a debtor's claims of exemption in order to preserve the trustee's right to administer any value in the asset in excess of the amount claimed as exempt. The Court stated that the Bankruptcy Code only requires a timely objection to an asset's categorization as exempt and does not apply to objections pertaining to the asset's value. In *Schwab*, the Debtor asserted an exemption for her business equipment in the amount of $10,718. She also listed the total value of the equipment in the amount of $10,718, claiming $1,850 of the value exempt under 11 U.S.C. § 522(d)(6) and $8,868 under 11 U.S.C. § 522(d)(5). Because the exemption amount listed on Schedule C was within the limits of the available exemptions, the Trustee did not object. The Chapter 7 Trustee subsequently sought to sell the equipment after an appraisal indicated that the equipment was worth considerably more than the amount listed on the schedules.

Property Of The Estate

When a debtor files a Chapter 7 bankruptcy petition, all of the debtor's assets become the property of the bankruptcy estate. Under Federal Rule of Bankruptcy Procedure 4003(b), "a party in interest may file an objection to the list of property claimed as exempt within 30 days after the meeting of creditors held under § 341(a) is concluded." 11 U.S.C. § 522(l) states, "[u]nless a party in interest objects, the property claimed as exempt on [Schedule C] is exempt." The debtor may claim exemptions under 11 U.S.C. § 522(b) and the trustee has a duty to object if the claimed amounts exceed the maximum values enumerated in 11 U.S.C. § 522(d).

Reviewing exemptions is an integral part of the Chapter 7 and 13 Trustees' role in administering a debtor's estate. In a Chapter 7, the Trustee utilizes the exemptions to determine what assets, if any, will be liquidated for the benefit of the debtor's creditors. Although a Chapter 13 debtor's assets are not liquidated by the Trustee, the Chapter 13 Trustee must ensure the unsecured creditors will receive what they would have received in a hypothetical Chapter 7 filing.

Schwab v. Reilly

In *Schwab,* the Debtor's exempt amount was equal to the value amount. The Debtor argued that this evidenced her intent to exempt and retain the entire asset. The Debtor asserted the Trustee had failed to object during the 30-day time period and thus forfeited the estate's claim to any portion of the business equipment. The Trustee contended the Debtor only exempted $10,718. If the property is worth more than this figure, she has only claimed an exemption of $10,718. The Debtor did not exempt her business equipment; she exempted an interest in the business equipment up to the value she claimed exempt. If her intention was to exempt the entire asset, then that intention must be *explicit*.

Prior to *Schwab*, the United States Supreme Court in *Taylor v. Freeland & Kronz*, 503 U.S. 638, 642-43, 112 S.Ct. 1644, 1648 (1992), held that a Chapter 7 trustee's objection to a debtor's exemption in an "unknown value" in a pending lawsuit was untimely. When a lawsuit was later found to have substantial value, the Trustee was unable to recover the asset because the 30 day time period had expired. The Court ruled that an exemption of "unknown" value was objectionable on its face and the trustee must object to preserve the estate's interest in that asset.

In *Schwab*, the Court reversed the Third Circuit Court of Appeals' decision, concluding that the Third Circuit had misapplied *Taylor* to permit a debtor to claim an exemption for the full value of the property without explicitly stating the debtor's intention as such. The Supreme Court clarified that the Trustee has an obligation to object to exemptions when they are facially invalid.

> [W]e hold that [the trustee] was not required to object to [the debtor's] claimed exemptions in her business equipment in order to preserve the estate's right to retain any value in the equipment beyond the value of the exempt interest.

Schwab v. Reilly, 130 S.Ct. at 2669. Where debtors wish to exempt an asset for the full fair market value ("FMV"), debtors will increasingly indicate "100% of FMV" or "Full FMV" as suggested by the Court. However, if debtors wish to avoid litigation, they may choose not to employ this tactic. On the other hand, the Trustees must be on alert and object when debtors use the "magic words" prescribed by the Supreme Court. Trustees undoubtedly will create "form" objections to exemptions to protect the interests of the creditors.

<u>Ethical Considerations</u>

For a debtor attorney, consideration must be given to whether advising a debtor to list "100% FMV" is ethical. 11 U.S.C. § 527(a)(2)(B) indicates, "all assets and liabilities are required to be completely and accurately disclosed in the documents filed to commence the case." Debtor's counsel must also maintain records to support the schedules under 11 U.S.C. § 527. Rule 1008 requires the bankruptcy filings to be verified or contain unsworn declaration. 18 U.S.C. § 152 permits criminal penalties for fraud in bankruptcy. *Schwab* may open the door to potential Rule 9011 sanctions. The court may be asked to determine whether the debtor's schedules were filed in good faith. Finally, if an attorney is unaware of *Schwab*, the attorney may commit malpractice if he or she does not complete Schedule C properly.

Result of *Schwab v. Reilly:* More Litigation!

Consensus among the bankruptcy community is that *Schwab* was not a complete win for the Trustees. The United States Supreme Court specifically provided "magic words" practitioners could use in exempting an asset in full. Utilizing "100% FMV" terminology is simple enough for bankruptcy practioners. However, at what cost does it really benefit the debtor? Everyone loses with rising litigation. There is extra cost imputed to the debtor, debtor counsel, and trustee as well as an additional burden placed upon the courts. When a debtor claims an asset is exempt indicating "100% FMV" on Schedule C, the Trustee is forced to file an objection to protect the estate's rights. This is essentially a needless objection where the debtor has the burden to support valuation.

Dependents, Residences and Domiciles

John C. Lange, Esq.

1. WHAT IS A DEPENDENT?

A. 11 U.S.C. § 522(d)(11)(E)

Section 522 (d)(11)(E) allows an exemption for payments in compensation of loss of future earnings of the debtor or an individual of whom the debtor is or was a dependent. Such property is exempt to the extent reasonably necessary for the support of the debtor and any dependent of the debtor.

Such a payment qualifies for the exemption if the debtor shows:

1. The annuity payment constitutes property that is traceable to a payment in compensation of loss of future earnings, and
2. The debtor is or was a dependent.

The discounted value of an annuity payment due in the future qualifies for the exemption but must be clearly traceable to compensation for loss of future earnings that are or were intended for support of the debtor or any dependent. Claims ancillary to or supplementing compensation for future earnings loss are ineligible for the exemption. The court examines the intentions of the parties when the settlement was effected to determine whether the annuity was intended as a payment in compensation of loss of future earnings or for some other purpose. See *In re Marble,* 2010 U.S. Dist. LEXIS 81881 (E.D. Mich. Aug. 12, 2010).

For example, a payment traceable to a loss of consortium claim is not a payment in compensation for loss of future earnings and therefore does not qualify for the exemption. With *In re Marble*, the court did not specifically define "dependent" but indicated that the debtor did not meet the second criteria because he was not a dependent at the time payment was made.

B. Defining "Dependent" Under the Bankruptcy Code

The Bankruptcy Code does not generally define the term "dependent." However, 11 U.S.C. §522(a)(1) does state that " 'dependent' includes spouse, whether or not actually dependent." Judge Spector had an opportunity to address the issue in the case of *In re Gonzazles*, 157 B.R. 604 (Bankr. E.D. Mich. 1993). In that case, the debtors argued that a dependent should be "a person who is supported financially by the debtor and who reasonably relies on such support." Judge Spector adopted the debtor's proposed definition, but with a clarification. He said, "One could certainly argue that it is always 'reasonable' for the recipient of financial assistance to rely on such assistance: the more pertinent question is whether it is reasonable under the circumstances for the court to permit the debtor to undertake the obligation of supporting the would-be dependent." *Gonzales,* 157 B.R. at 609.

> For example, a Chapter 13 debtor may propose to donate virtually all of her income to an orphanage with unsecured creditors being paid only a small percentage of their claims. If the debtor argued that the orphans are her dependents, it makes little sense for the court to launch an inquiry into whether these children 'reasonably rely' on the debtor's support. The real issue is whether it is reasonable to permit the debtor to assume such an obligation. *Id.*

Another interesting discussion of the term dependent is found in the case of *Miller v. Riverside Storage & Cartage Co,* 189 Mich. 360 (Mich. 1915). There the court stated that "'dependent' probably means dependent for the ordinary necessaries of life for a person of that class and position in life. The test of dependency is not whether the family could support life without the contributions of the deceased, but whether they depended upon them as part of that income or means of living."

2. WHAT IS A RESIDENCE?

A. Personal Residence Under 11 U.S.C §522(d)(1)

What is the criteria for property qualifying for the personal residence exemption under 11 U.S.C. §522 (d)(1)?

11 U.S.C. § 522(d)(1) allows a $21,625 exemption for real or personal property that the debtor[1] uses as a residence. Notwithstanding broad interpretation as to what constitutes a residence, the courts consider factors such as the debtor's intent and conduct to determine whether property qualifies for the personal residence exemption. Additionally, the debtor must reside at the property as of the petition date to qualify for the exemption.

B. Qualifying for a Personal Residence Exemption

To qualify for the personal residence exemption, the debtor must actually or constructively occupy the dwelling as of the petition date. Two factors determine whether a debtor constructively occupies a property as his personal residence:

1. Whether the debtor vacated the dwelling before the petition date voluntarily or involuntarily, and
2. Whether the debtor intended at the time he vacated to move back in and reside in the dwelling.

The debtor's intent, conduct, and reasons why he vacated before the petition date establish the debtor's intended use and determine whether he constructively resided at a dwelling claimed as a residence. Similar to abandonment indicating lack of intent to reside in a dwelling, voluntarily vacating could indicate intent that the dwelling's

[1] Or a dependant of the debtor.

intended purpose was not a residence. The facts and circumstances as well as the debtor's conduct establish whether the dwelling is a residence qualifying for the personal residence exemption. See *Hickmont v. Frank,* 2010 U.S. Dist. LEXIS 31848 (E.D. Mich. Apr.1, 2010). The bankruptcy case number is 09-20493-dob.

C. Hypothetical Scenario

A debtor comes to see you to file a Chapter 7 case. He has a home in Southeast Michigan with no equity and wants to surrender it. He also has a home in Northern Michigan where he always intended to live in retirement. What advice would you give him to establish the second home as a personal residence?

3. WHICH STATE'S EXEMPTIONS APPLY?

A. Length of Time at Current Residence

Asking the debtor how long they have resided at their current address is NOT a question just to determine the proper venue.

The debtor must use the exemptions allowed by the state in which the debtor was domiciled for the 730 days preceding the filing of the petition. If the debtor has not resided in a single state for the last 730 days, then the state law which controls is the state in which the debtor was domiciled for the 180 days immediately preceding the 730 days or for the longest portion of the 180 day period. 11 U.S.C. §522(b)(3)(A).

> Domicile is not necessarily synonymous with 'residence.' One may reside in one place but be domiciled in another. 'Domicile' is established by physical presence in a place with the state of mind that one intends to remain there. *Miss. Band of Choctaw Indians v. Holyfield,* 490 U.S. 30, 109 S. Ct. 1597 (U.S. 1989).

Are attorneys and trustees making proper inquiry?
Are you competent to apply another state's exemptions?

Exemption Amendments,
Undisclosed Assets and Undervalued Assets

Rules Precluding Amended Claims of Exemption and Disclosure Obligations

David W. Allard, Esq.
David E. Schwartz, Esq.

Issue: **What are the limitations on a debtor's right to amend his or her bankruptcy schedules to claim new exemptions, including previously undisclosed or undervalued assets?**

Exemption Amendments

Discussion: The Federal Rules of Bankruptcy Procedure provide that a debtor may amend "[a] voluntary petition, list, schedule, or statement . . . as a matter of course at any time before the case is closed." F.R.B.P. Rule 1009. This rule has been described as allowing "liberal amendment of exemption claims." *In re Kaelin*, 308 F.3d 885, 889 (8th Cir. 2002). However, even a liberal policy has limits. When referring to belated claims of exemption, there are two main avenues by which courts will refuse to allow the amendment, prejudice to creditors and bad faith.

Prejudice to Creditors:

- In determining whether to deny an amendment to schedules on the basis of prejudice, the focus is on the effect of the amendment on creditors and other parties in interest. Mere delay in filing an amendment, or the fact that an amendment, if allowed, will result in the exemption being granted, are not sufficient to show prejudice. . . . [P]rejudice may be established by showing harm to the litigating posture of parties in interest. If the parties would have taken different actions or asserted different positions had the exemption been claimed earlier, and the interests of those parties are detrimentally affected by the timing of the amendment, then the prejudice is sufficient to deny amendment. Moreover, an amendment is prejudicial if it impairs a trustee in the diligent administration of the estate.

  - *In re Talmo*, 185 B.R. 637, 645 (Bankr. S.D. Fla. 1995)

- Possibility that amendment to list of property claimed as exempt might, if allowed, diminish estate or make it more difficult for Chapter 7 trustee to liquidate nonexempt assets was insufficient "prejudice" to creditors to warrant denying debtor's amendment of exemptions.
  - *In re Hardy*, 234 B.R. 94 (Bankr. W.D. Mo. 1999).

<u>Bad Faith:</u>

- Courts may refuse to allow an amendment where the property has been concealed or where the Debtor has acted in bad faith.
  - *In re Opra*, 365 B.R. 728, 743 (Bankr. E.D. Mich. 2007)
- In the context of an amendment of exemptions, bad faith is determined by an examination of the totality of the circumstances.
  - *In re Colvin*, 288 B.R. 477, 481 (Bankr. E.D. Mich. 2003).
- A Debtor's bad faith can be inferred from the Debtor's reckless disregard for the truth.
  - *Bauer v. Iannocone* (*In re Bauer*), 298 B.R. 353 (8th Cir. B.A.P. 2003).

Disclosure Obligations: The effect of the foregoing is that debtors and their attorneys should consider the consequences of the belated claims of exemption and the effect those new claims of exemption have on the administration of the case. The debtor's attorney should consider who has relied on the original exemptions and to what extent they may be prejudiced. Debtor attorneys may also face consequences if there was an asset that wasn't included on the original schedules. *See e.g. In re Shannon*, 2010 WL 1246691 (E.D. Mich., March 25, 2010).

Undisclosed Assets

Discussion: The most likely basis a Trustee will rely upon in seeking to have a claim of exemption denied is that the debtor acted with bad faith by attempting to conceal an asset from the Bankruptcy Court and the debtor's creditors.

- The Debtor is under an affirmative duty to disclose all of his assets to the Bankruptcy Court.
  - *Browning v. Levy*, 283 F.3d 761 (6th Cir. 2002).
- "[T]he disclosure obligations of consumer debtors are at the very core of the bankruptcy process and meeting such obligations is part of the price debtors pay for receiving the bankruptcy discharge."
  - *In re Colvin*, 288 B.R. at 481.
- "If debtors could omit assets at will, with the only penalty that they had to file an amended claim once caught, cheating would be altogether too attractive. . . . When it is hard to detect an effort to evade the law, the penalty must exceed the profits of the evasion."
  - *In re Opra*, 365 B.R. at 746.

- When it is discovered that a debtor has attempted to hide an asset, it will generally support a finding of bad faith.
  - *In re Doan,* 672 F.2d 831, 833 (11th Cir. 1982) ("We agree that concealment of an asset will bar exemption of that asset.").

Courts look at several factors when inquiring into whether a debtor has attempted to conceal an asset. Mere allegations that the debtor acted in bad faith are insufficient though, the objecting party will need to demonstrate bad faith with specific evidence. *See In re Colvin,* 288 B.R. 477 (Bankr. E.D. Mich. 2003). Relevant evidence includes:

(1) The debtor's knowledge of the asset at the time he or she filed their bankruptcy petition;

(2) The time between when the debtor became aware of the asset and the time when the debtor filed his or her amended claims of exemption;

(3) The value of the asset and the debtor's ability to exempt it in whole or in part; and,

(4) The current status of the asset (i.e. was it cash the debtor already spent)

Undervalued Assets

Discussion: Similar issues also arise when debtors undervalue assets in an attempt to protect them from administration in the bankruptcy case. The Supreme Court's ruling in *Schwab v. Reilly*, 130 S.Ct. 2652 (June 17, 2010), not only clarified that Trustees are not required to object to a debtor's valuation, but also explained the Court's view concerning the estimated value debtors attribute to assets in their schedules:

- "We simply confine the estimate to its proper role: aiding the trustee in administering the estate by helping him identify assets that may have value beyond the dollar amount the debtor claims as exempt[.]"
    - *Schwab v. Reilly*, 130 S.Ct. at 2663.

Even limited to the role of aiding the Trustee, significant undervaluing of assets can be a basis for a finding bad faith:

- "Debtor's omissions from and low valuation of his personal property on Schedule B was, at the very least, a false oath made in reckless disregard for the truth and a deliberate attempt to undervalue property, shield available assets from creditors, and deprive the Trustee of incentive and opportunity to conduct such an investigation."
    - *In re Koss*, 403 B.R. 191, 215 (Bankr. D. Mass. 2009) (arising in the context of denial of discharge).

Tax Refunds – Wherefore are Thou?

<u>Can I still exempt them?</u>

Jeff A. Moyer, Esq.

Issue: Debtors fail to list tax refunds on Schedule B (B.18 or B.21) – When, or how long can the debtors and amend schedules to exempt those assets?

Discussion: The Bankruptcy Code provides deadlines for when assets must be listed on any given set of schedules filed with, or within 15 days of filing a bankruptcy petition. FRBP 1007(c). After that 15 days has expired, the fundamental rule allowing debtors to amend, or add to their schedules is governed by the provisions of FRBP 1009(a) which states "A voluntary petition, list, schedule, or statement may be amended by the debtor as a matter of right at any time before the case is closed.". A landmark case for amending schedules is the Sixth Circuit opinion of *Lucuis v McLemore*, 741 F.2d 125 (6th Cir. 1984).

Based upon a growing conclusion over the last several years that debtors were simply not disclosing either not-yet-received tax refunds for the prior year, or any estimate of the accrued tax refund for the year of filing, the panel trustees in both the Eastern and Western Districts of Michigan have placed increased emphasis on identifying and pursuing non-disclosed (and non-exempt) tax refunds.

There is no question that tax refunds for the year in which the debtor files bankruptcy constitute property of the debtor's bankruptcy estate. *Araj v. Kohut,* 371 B.R. 240, 243 (E.D. Mich. 2007); *Johnston v. Hazlett,* 209 F.3d 611 (6th Cir. 2000); *Kokaszka v. Belford,* 417 U.S. 642 (1974); *Segal v. Rochelle,* 382 U.S. 375 (1966). Likewise, it is accepted practice to pro-rate a given year's tax refund to the date of filing to determine what pre-petition portion of that tax refund would constitute property of the debtor's bankruptcy estate for purposes of §541(a). *In re*

Donnell, 357 B.R. 386 (Bankr. W.D. Tex. 2006); See also *Arabian v. Coleman*, 338 F.2d 41, 43 (6th Cir. 1964).

As a result of that increased awareness, the Bankruptcy Court in both Districts have released a number of opinions over the last three years generally restricting the debtors' ability to simply amend their schedules at any time to add previously undisclosed and non-exempted tax refunds. The Bankruptcy Courts have incrementally made it more and more difficult for debtors to omit tax refunds from their original schedules, and then simply file amended schedules later disclosing and exempting those refunds for the first time without ramifications. Some of the relevant decisions are briefly summarized as follows:

- *In re Colvin* – 288 B.R. 477 (Bankr. E.D. Mich. 2003) Judge Rhodes set out 7 factors to be considered when Debtors failed to disclose entitlement to tax refund of $10,000 and ultimately denied amended schedules seeking to exempt undisclosed refunds.
- *In re LaRoche* – 409 B.R. 862 (Bankr. E.D. Mich. 2009) Judge Opperman held Debtors duty-bound to disclose refunds, or correct amount of understated refunds, to be done within 14 days of finding out the correct amounts. The Court allowed the amended schedules and overruled the Trustee's Objection.
- *In re Fleming* – 424 B.R. 795 (Bankr. W.D. Mich. 2009) Judge Hughes held trustee should take action to obtain control and possession of undisclosed tax refunds within 60 days of finding out of its existence. Judge also ruled debtors would be strictly liable to estate if they spent refunds before disclosing and attempting to properly exempt them.
- *In re Trudell* – (W.D. Mich. 2010 - not published) In sua sponte follow-up to published opinion holding Trustee's objection was moot based upon the Debtor having already exhausted the tax refunds, the Court imposed $1,000 sanction on Debtor's attorney after

taking expert testimony for failing to list any tax refunds in 69 out of 70 cases filed in one year period in violation of §707(b)(4)(D).

<u>What about Closed Cases?</u>

Both the Eastern and the Western Districts have made greater use of IRS tax refund intercepts in which the IRS will forward non-exempt tax refunds directly to the trustee. However, the Western District has gone one step further. There have been a large number cases where the trustee filed an IRS intercept while the case was open, closed the case as an otherwise "No Asset" case with the Court, and then moved to re-open the case to administer undisclosed assets when the IRS refund check comes in the mail directly to the trustee.

Not surprisingly, many debtors moved to amend their schedules after the case was re-opened to attempt to exempt those previously undisclosed refunds. While the Bankruptcy Court in the Western District has not yet issued any written opinions on that fact pattern, the amendments have been uniformly denied, to varying degrees based upon either the limiting language contained in FRBP 1009(a), and/or the holding in *In re Blose*, 2009 WL 2982932 (Bankr. W.D. Ky. 2009) where Judge Stosberg held that judicial estoppel barred a debtor from amending [her] schedules to exempt an undisclosed asset (cause of action) after the case was re-opened by the trustee, citing the three criteria examined by the Supreme Court in *New Hampshire v. Maine*, 532 U.S. 742, 750 (2001). Judge Stosberg also examined those Court of Appeals decisions limiting the application of judicial estoppel in *Eubank v. CBSK Finan. Group, Inc.*, 385 F.3d 894, 898 (6th Cir. 2004); *Browning v. Levy*, 283 F.3d 761 (6th Cir. 2002), and *In re Coastal Plains*, 179 F.3d 197 (5th Cir. 1999).

While *Blose* was not a tax refund case, its application is important for assets omitted by debtors from their schedules which are later discovered and brought to the trustee's attention.

Exemption of Property held by Tenants by the Entireties

Maria Gotsis, Esq.

Issue: **When may a debtor exempt property held as tenants by the entireties?**

Rules:

11 U.S.C. § 522(b)(3)(B):

> [A]ny interest in property in which the debtor has, immediately before the commencement of the case, an interest as a tenant by the entirety or joint tenant to the extent that such interest as a tenant by the entirety or joint tenant is exempt from process under applicable nonbankruptcy law.

M.C.L. § 600.5451(1)(o):

> Property described in section 1 of 1927 PA 212, MCL 557.151, or real property, held jointly by a husband and wife as a tenancy by the entirety, except that this exemption does not apply with regard to a claim based on a joint debt of the husband and wife.

E.D. Mich. LBR 4003-1 Entireties Exemption:

> A married debtor not filing a joint petition who claims property as exempt under tenants by the entireties law shall state whether each debt listed on schedules D, E and F is a joint debt with the non-filing spouse or is the sole debt of the debtor. For purposes of determining whether the debtor's claim of exemption under state entireties law should be allowed, there shall be a rebuttable presumption that any debt listed on schedule D, E or F that is not clearly disclosed as the sole debt of the filing spouse is the joint debt of both spouses.

<u>Discussion:</u>

In the case of *Nino v. Moyer*, 2009 WL 416295 (Feb. 18, 2009), the United States District Court for the Western District of Michigan reversed the Bankruptcy Court's decision that an exemption under tenants by the entireties was invalid. The Debtor transferred property held as tenants by the entireties to his wife on the day he filed for relief under the Bankruptcy Code. Later, the property was transferred back to the debtor and his wife as tenants by the entireties. The Court held, "without a finding that [there] was a preferential transfer, the Court is not persuaded by the reasoning of the Bankruptcy Court that interests of the creditors of Debtor were harmed…."*Id* at *7.

Under Michigan law, property obtained by a husband and wife is presumed to be held as tenancy by the entireties. Contrast the following two cases:

-*Zavradino v. JTRB*, 482 Mich. 858, 753 N.W. 2d. 60 (Mich. 2008) where the Supreme Court of Michigan upheld the Court of Appeals decision that a designation of "JTWROS" and "JRS" are insufficient to overcome the statutory presumption in favor of a tenancy by the entirety. The Proberts were married when the account was opened and the presumption applied.

- *In re Musilli*, 06-55963 (March 13, 2009) The Debtor, Ralph Musilli and his wife were not married at the time the cash management account was opened. The Court concluded, the "CMA account is not held as tenants by the entireties and is not eligible for exemption pursuant to M.C.L. § 600.5451(1)(o)." *Id.* at *5.

Constitutionality of State Law Exemptions

Constitutionality of MCLA §600.5451

Jeff A. Moyer, Esq.

The Michigan legislature passed a revised exemption statute in 2005 which for the most part provided greater protection for individuals, but ***only*** applied to persons in bankruptcy proceedings. A trilogy of cases in the Western District of Michigan have called into question whether a bankruptcy specific exemption statute is Constitutional under the Supremacy Clause of the Constitution, U.S. Const. art. VI, cl. 2. *In re Wallace*, 347 B.R. 626 (Bankr. W.D. Mich. 2006) (J. Hughes); *In re Pontius*, 421 B.R. 814 (Bankr. W.D. Mich. 2006) (J. Gregg); *In re Jones*, 428 B.R. 720 (Bankr. W.D. Mich. 2010) (J. Dales) – on appeal. Judge Rhodes also addressed the Constitutionality of MCLA §600.5451 from a different analysis in *In re Sassak*, which was affirmed on appeal by District Judge Borman, 426 B.R. 680 (E.D. Mich. 2010), but that primarily addressed whether a debtor in bankruptcy, after electing to utilize state law exemptions, was limited to only those enunciated in MCLA §600.5451.

These comments are merely a condensed version of the appellate briefs filed by the two Chapter 7 Trustees, the respective debtors and an Amicus brief in the cases of Steven Schafer and Dorothy Jones in the consolidated appeal currently before the Sixth Circuit Bankruptcy Appellate Panel on the issue of the constitutionality of bankruptcy specific State law exemptions. Given that the briefs have been on file since June and July, it is possible there will be an answer from the BAP by the time of this seminar.

Trustee's Arguments

The heart of the Trustees' argument revolves around a very thorough examination of the Bankruptcy Clause of the Constitution, U.S. Constitution, Article I, §8, Clause 4. The Trustees' brief goes into great detail in examining what powers the Bankruptcy Clause allows to be delegated to the States, what the effect the "opt out" provisions of §522(b)(2) means, and finally examines with some precision the definition of "uniform" as it is used in the Bankruptcy Clause of the Constitution where it tasks the Congress to establish uniform laws of bankruptcy throughout the United States. The Trustees' position is supported by the recent holdings of Judge Hughes' opinion in *In re Wallace*, as well as Judge Gregg's decision in *In re Pontius*, both of which interpreted the Sixth Circuit's opinion in *Hood v Tennessee Student Assistance Corp.,* 319 F.3d 755 (6^{th} Cir. 2003), *affirmed on other grounds*, 541 U.S. 440 (2004), to support their conclusions.

It is the Trustees' position that "uniform" requires geographical uniformity such that all the debtors in a given area like the State of Michigan are to be treated the same, rather then different treatment for different classes of people within the state. The Trustees point to *Hanover National Bank v. Moyses*, 186 U.S. 181 (1902) for the proposition that geographical uniformity is required such that a trustee in each state would be able to take whatever would be available to creditors if the bankruptcy law had not been passed. The Trustees go on to state that MCLA §600.5451 represents an impermissible attempt by the State to write, or re-write Federal Bankruptcy law in violation of the Supremacy Clause of the Constitution. Interestingly enough, the Trustees on one side and the Debtors as well as the Amicus brief on the other side focus on essentially the same Supreme Court and Sixth Circuit case law, yet reach entirely different results.

<u>Debtors' Arguments</u>

The Debtors' arguments focus primarily on the plain meaning of the language in §522(b)(3)(A) which allows debtors in Michigan to utilize applicable State law. Their argument is also based in large part upon the assertion that the States maintain concurrent authority to promulgate bankruptcy laws and cite to *Sturges v. Crowninshield,* 17 U.S. 122 (1819), a decision that interestingly was issued between the repeal of the first Bankruptcy Act of 1800 in 1803 and Congress' second attempt in passing the Bankruptcy Act in 1841 while there was no Federal bankruptcy statute in existence. That argument does find some support, however, in more recent opinions such as *Storer v. French,* 58 F.3d 1125 (6th Cir. 1995) and *Rhodes v. Stewart*, 705 F.2d 159 (6th Cir. 1983).

The Debtors also assert they have support in several other jurisdictions that have already ruled on the issue of bankruptcy specific exemptions around the country. *Sheehan v. Peveich,* 574 F.3d 248 (4th Cir. 2009); *In the Matter of Kulp*, 949 F.2d 1106, 1109 fn. 3 (10th Cir. 1991); *In re Brown,* 2007 WL 2120380 (Bankr. N.D. N.Y. 2007); *In the Matter of Shumaker*, 124 B.R. 820 (Bankr. D. Mont. 1991); *In re Vasko,* 6 B.R. 317, 321 (Bankr. N.D. Ohio 1980).

The Debtor go on to assert that the Uniformity Clause is merely a limitation on Congressional acts, not on the States' ability to formulate laws, citing to *Railway Labor Exec. Assoc. v. Gibbons,* 45 U.S. 457, 469 (1982); *Sticka v. Applebaum,* 422 B.R. 684 (9th Cir. BAP 2009).

Amicus Brief by Five Debtor/ Consumer Organizations

There was an Amicus brief filed in the consolidated appeal as a combined effort from the National Association of Consumer Bankruptcy Attorneys ("NACBA"), the National Consumer Law Center (NCLC), the Legal Services Association of Michigan (LSAM), the Michigan Poverty Law Program (MPLP) and the Council of the Consumer Law Section of the State Bar of Michigan.

The Amicus brief primarily took the same positions as the Debtors' briefs did, stating that the Trustees' reading of *Hood* was overly broad, that their reading of *Hanover* was no longer accurate as quoted. The Amicus brief emphasized the language in §522(b)(3)(A) which allows debtors to utilize "applicable" State law. They cite to *Owen v. Owen*, 500 U.S. 305, 308 (1991) for the proposition that nothing in the Bankruptcy Code limits a State's powers to fashion bankruptcy law exemptions that are recognized and given effect under §522(b)(3)(A).

The Amicus brief also argues that the Trustees' position, that uniformity in application is required, is based upon an unduly narrow reading of *Hanover* which is no longer current law. It also draws a distinction between geographical uniformity and class uniformity, as demonstrated by the case of *In re Verasani, 394* B.R. 430 (Bankr. S.D. Ohio 2008).

<u>Conclusion</u>

Both sides raise valid points and have support from other jurisdictions. Both sides have certain weaknesses in their positions, yet make powerful and persuasive arguments in support of their urged outcome. Stay tuned for a decision to be rendered soon by the Bankruptcy Appellate Panel , and in all likelihood, a Sixth Circuit Court of Appeals decision to follow.

Pay That Exemption!

Can a Trustee be Compelled to Pay the Debtor's Claim of Exemption Before the Case is Closed?

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Issues: **(1) When is a Trustee required to pay the debtor their claim of exemption in property which the Trustee has administered?**

(2) Can the Trustee be compelled to pay the exemption?

Discussion: Upon the filing of a debtor's bankruptcy petition, and subject to some exclusions, "all legal or equitable interests of the debtor in property as of the commencement of the case" become property of the bankruptcy estate. 11 U.S.C. § 541(a)(1). Notwithstanding the operation of section 541 and the inclusion of the debtor's property into the estate, debtors are permitted to exempt certain property from 'property of the estate' pursuant to section 522. But a debtor's exemption is limited to the value claimed exempt meaning that the trustee may administer assets so long as there are sufficient proceeds generated from administration of those assets to pay the debtor's claim of exemption in the same:

- "Section 522(d)(5) contemplates exemptions limited by a maximum monetary amount; it does not provide for 'in kind' exemptions."
  - *In re Lewandowski*, 386 B.R. 643, 646 (E.D. Mich. 2008).
  - *See also Schwab v. Reilly*, 130 S.Ct. 2652 (June 17, 2010).

The question which ultimately results from the Trustee's sale of estate property is when the Trustee may be required to pay the debtor's claim of exemption in the property sold. This in turn requires an examination of the Trustee's duties and obligations under the Bankruptcy Code.

<u>Trustee's Duties</u>

Many of the duties trustees have are explicitly set forth in the section 704 of the Bankruptcy Code. Those duties relevant to the Trustee's obligation to pay exemptions require that the Trustee shall:

- Collect and reduce to money the property of the estate for which such trustee serves, and close such estate as expeditiously as is compatible with the best interests of parties in interest;
- Be accountable for all property received;
- Investigate the financial affairs of the debtor; and,
- Make a final report and file a final account of the administration of the estate with the court and with the United States trustee;

Interestingly, no duties specifically require the Trustee to pay a debtor's claim of exemption before the case is closed and the Trustee files his final report. *See In re Kaufman*, 68 B.R. 391 (Bankr. S.D. N.Y. 1986).

<u>"Reasonableness" Test</u>

Because no section of the Bankruptcy Code specifically states when the Trustee may be obligated to pay a debtor's exemption, at least one court faced with the possibility of compelling the Trustee to pay the debtor's exemption has applied a reasonableness test. *See Greene v. Balaber-Strauss,* 76 B.R. 940, 942 (S.D.N.Y. 1987). The test permits the Trustee a reasonable time to conclude administrative fiduciary duties relative to the estate and the debtor's financial affairs. Only after the Trustee has concluded these administrative duties must the debtor's exemption be paid. Whether a trustee has had "reasonable time" depends in part on the extent to which the debtor has cooperated with the trustee and furnished documents and information which the trustee requires. *See In re Kaufman*, 68 B.R. 391 (Bankr. S.D. N.Y. 1986) (applying this inquiry to the trustee's duty to investigate competing claims to determine that there are no superior nondischargable claims).