

# **Is It Worth It? Advanced Valuation Issues in 7s, 13s and Individual Chapter 11s**

Presented by the Consumer Committee

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# CONVERSION OF INDIVIDUAL CHAPTER 11 CASE TO CHAPTER 7

By Cecilia Lee, Esq.

## Chapter 13 to Chapter 7

- Post-petition earnings are property of the debtor and not the chapter 7 trustee: 11 U.S.C. §348(f)(1)
- Undistributed plan payments consisting of post-petition earnings in hands of chapter 13 trustee are property of the debtor: *Harris v. Viegeln*, 135 S. Ct. 1829 (2015).

## Individual Chapter 11 to Chapter 7

- §348(a) addresses effect of conversion:

“Conversion of a case from a case under one chapter of this title to a case under another chapter of this title constitutes an order for relief under the chapter to which the case is converted, but, except as provided in subsections (b) and (c) of this section, does not effect a change in the date of the filing of the petition, the commencement of the case, or the order for relief.”

### Effect of §348(f)(1)

- §348(f)(1) provides that except in instances of bad faith conversion,

“when a case under chapter 13 of this title is converted to a case under another chapter under this title – (A) property of the estate in the converted case shall consist of property of the estate, as of the date of filing of the petition, that remains in the possession of or is under the control of the debtor on the date of conversion[.]”

## Does §348(a) or §348(f)(1) control?

- *In re Markosian*:
  - Chapter 11 debtors converted their case to chapter 7 and received substantial bonus that was earned during the chapter 11 after the conversion.
  - Bankruptcy Court held that bonus was property of the estate pursuant to §1115(a)(2):
    - includes as property of the estate “earnings from services performed by the debtor after the commencement of the case but before the case is closed, dismissed, or converted to a case under chapter 7, 12, or 13, whichever occurs first.”

### BAP focuses on §348(a)

- §1115(a)(2) was not raised on appeal;
- BAP reasoned on conversion, §348(a) applies
- Property of the estate determined as of petition date, not conversion date
- This summons the exclusion of §541(a)(6) of earnings for personal services
- Earnings that were property of the estate in chapter 11 are recharacterized as excluded by §348(a) and §541(a)(6) upon conversion

## *Markosian*: silence in §348(f)(1) does not equal Congressional intent

- *Markosian* distinguished cases that rely on similarity between §1306 and §1115 to capture §1115 property as property of the converted case
- Ninth Circuit and Supreme Court law: legislative silence is not a basis for statutory construction

## The split of authority

- *In re Meier*:
  - Bankruptcy court held *Markosian* reasoning is incorrect that there was no need to amend §348(f) further because §348(a) is the controlling statute
  - Relied on *In re Lybrook*, a 1991 Seventh Circuit case that held chapter 13 post-petition earnings are property of chapter 7 estate

## *Meier* Bankruptcy Court: *Lybrook* the law in the Seventh Circuit

- *Lybrook* applies, Bankruptcy Court reasoned because “[i]f Congress meant to reject the rule in *Lybrook* generally instead of only in chapter 13, it could have done so. Instead, there is an express statutory command that rejects the *Lybrook* rule for conversions from Chapter 13. §348(f)(1).”

## *Meier* District Court agrees

- Acknowledged §348(a) BUT mindful of §348(f)
- §348(a) less specific
- Rejected argument that §348(a) applies in chapter 11 conversion and that §348(f) applies only to chapter 13 conversion
- Criticized *Markosian* on ground that nothing in §348(a) indicated §348(f) is merely a clarification for chapter 13; §348(f) makes no mention of §348(a)

## Split of authority continuing to develop

- Other courts in Seventh Circuit beginning to weigh in
- Recently, *In re Gorniak* adopted *Meier* reasoning and held bound to apply *Lybrook*
- Congressional or Supreme Court resolution?

# Liquidation Analysis

presented by  
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## Overview of Best Interest of Creditors [Liquidation Analysis]

- Duties of a Chapter 13 Trustee
- Summary of Best Interest of Creditors Test[Liquidation Analysis]
- Overview of a chapter 13 pre-confirmation review
- Typical chapter 13 liquidation related objections
- Conclusion

## Chapter 13 Trustee Duties

As defined in the Handbook for Chapter 13 Standing Trustees prepared by the Executive Office for United States Trustees

- The statutory duties of the standing trustee are set forth in part in §1302 which incorporates by reference some of the duties of chapter 7 trustees set forth in § 704.

## Duties of A Standing Trustee

- These duties include, but are not limited to, the requirements that the standing trustee:
  - 1. **be accountable for all property** received [§ 704(2)];
  - 2. **investigate the financial affairs of the debtor** [§ 704(4)];
  - 3. if a purpose would be served, **examine proofs of claim and object to the allowance of any claim that is improper** [§ 704(5)];
  - 4. if advisable, **oppose the discharge of the debtor** [§ 704(6)];

## Duties of A Standing Trustee

- 5. unless the court orders otherwise, **furnish such information concerning the estate and the estate's administration as is requested by a party in interest** [§ 704(7)];
- 6. **make a final report and file a final account of the administration** of the estate with the United States Trustee and the court [§ 704(9)];
- 7. **appear and be heard at any hearing** that concerns, a. the value of property subject to a lien [§ 1302(b)(2)(A)]; b. confirmation of a plan [§ 1302(b)(2)(B)]; or c. modification of the plan after confirmation [§ 1302(b)(2)(C)].

## Duties of A Standing Trustee

- 8. advise, other than on legal matters, and assist the debtor in performance under the plan [§ 1302(b)(4)];
- 9. ensure that the debtor commences making timely payments under § 1326 of this title [§ 1302(b)(5)]; and,
- 10. if the debtor is engaged in business, investigate the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business and the desirability of the continuance of such business, and any other matter relevant to the case or to the formulation of a plan [§ 1106(a)(3)].

## Best Interests of Creditors Test (Liquidation Analysis)

As stated in handbook

- Section 1325(a)(4) provides that the court may only confirm a plan **if the value, as of the effective date of the plan**, of property to be distributed under the plan on account of each allowed unsecured claim **is not less than** the amount that **would be paid on such claim if the estate of the debtor were liquidated under chapter 7** of this title on such date

## Liquidation Analysis [Con't]

- The standing trustee should **conduct a liquidation analysis of real and personal property** prior to confirmation or modification of a plan.
- **Liquidation value** is determined by **subtracting allowed exemptions and claims secured by the debtor's property**, along with expenses allowed under § 506 of the Code, from the value of the debtor's property.
- Depending upon controlling law, hypothetical costs of **sale and capital gains tax may also be deducted.**

# Liquidation Analysis

## [Con't]

- Section 541 defines **property of the estate** generally as all **legal and equitable interests of the debtor**. If appropriate, the standing trustee **should include potential preferential or fraudulent transfer recoveries** as part of the value of the estate.
- Denial of improper claims of exemption and invalid or unperfected liens should be considered.
- The value of any distribution under chapter 13, "as of the effective date of the plan, " **must be not less than the value of a distribution if the case were converted to chapter 7**
- **plan payments to unsecured creditors must equal or exceed the chapter 7 liquidation value**

## Case review by Trustee

### OVERVIEW OF PRE-CONFIRMATION REVIEW

- Proof of Service
- Plan Issues
- Proof of Income
- Best Efforts- "Subject to Means Test"
- Eligibility
- Liquidation
- Objection to Exemption

## Case review by Trustee [Con't]

- OVERVIEW OF PRE-CONFIRMATION REVIEW [con't]
  - Schedules
  - Forms
  - Means Test
  - Prior Bankruptcies
  - Feasibility

## Typical Trustee Objections

### Liquidation

Upon review of all schedules and plan, trustee objections may include:

- All assets not scheduled
- Spouses assets not scheduled
- Provide fair market value of:
  - Real property
  - Automobile
  - Personal property

## Typical Trustee Objections Liquidation [Con't]

- Fair market value of real property greater than scheduled
- Provide fair market value of:
  - business
  - Stocks
- Chapter 7 distribution would be greater than proposed plan percent

## Conclusion

- Best Interest of Creditors Test [Liquidation Analysis]
  - Integral part of chapter 13 plan.
  - Important if case is converted to chapter 7.
  - Provides additional payments to unsecured creditors.
  - Can be challenging to receive all required information from the debtor.
  - Become more important in a strong economy.

# Valuation of A Debtor's Interest in Limited Liability Business Entities: A 9<sup>th</sup> Circuit Approach

Robert P. Reynolds

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## Limited Liability Companies and Partnerships

- Bankruptcy Code does not define LLC
  - However, the Code does specifically mention partnerships and partners
- Valuation of a member's interest is complicated when the interest is separated into two parts: economic rights and management rights



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## Single Member LLC

- In single member LLC, most legislation does not address the rights of a member to transfer their interest
  - Generally, the trustee/debtor in possession will gain both the economic and management rights of the member's interest as property of the estate under § 541



## Multi-Member LLC

- In multi-member LLC, transfer of member's interest is usually restricted by either:
  - State law
  - LLC's operating agreement
    - The determination of the trustee's control over the management rights will depend on whether the entity's operating agreement is an executory contract
    - If the operating agreement is not an executory contract, the trustee/debtor in possession will retain both the economic and management rights under § 541
    - However, if the operating agreement is an executory contract, the extent of the trustee's rights will depend on a detailed analysis of § 365

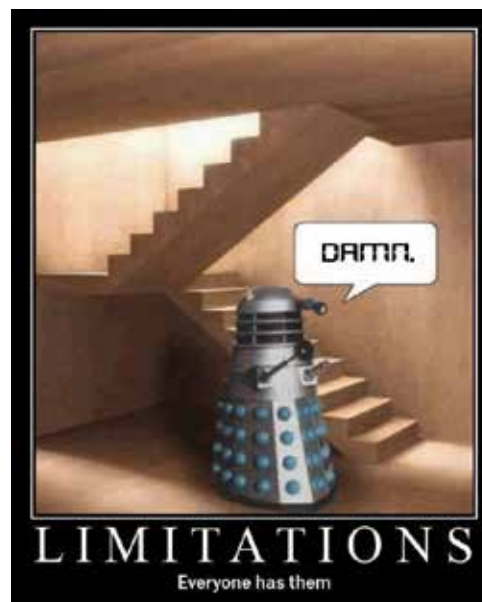
## Property of the Estate

- 11 U.S.C. § 541(c) (2012):

“(1) Except as provided in paragraph (2) of this subsection, an interest of the debtor in property becomes property of the estate under subsection (a)(1), (a)(2), or (a)(5) of this section notwithstanding any provision in an agreement, transfer instrument, or applicable nonbankruptcy law –

  - (a) that restricts or conditions transfer of such interest by the debtor”
- LLC and LLP operating agreements may include provisions to modify, forfeit, or terminate a debtor member’s/partner’s interest in the entity upon commencement of bankruptcy
  - But these clauses are usually invalidated by anti ipso facto clauses found in the Code

## Limitations on § 541



## 11 U.S.C. § 365

- If the entity's operating agreement is determined to be an executory contract, § 365 will govern the trustee/DIP's rights
  - The restrictive portions of state law limiting the property of the estate could be enforced by operation of § 365
- §§ 365(c)(1) and (e)(2) include limitations that suggest bankruptcy courts may still enforce the restricting provisions in an entity's operating agreement that are triggered by a debtor member/partner filing bankruptcy
  - Operation of these clauses is a judicial debate, settled by use of the 'hypothetical' or 'actual' test
  - Ninth Circuit employs the hypothetical test

## LLC – Single Member

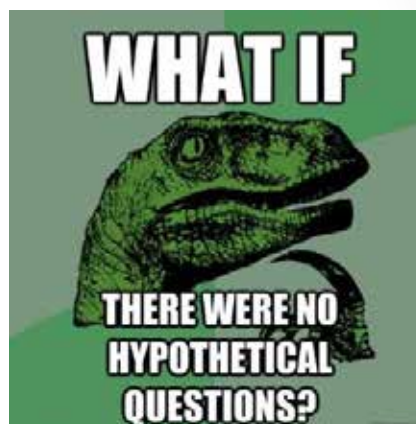
- In re First Prot., Inc., 440 B.R. 821 (B.A.P. 9th Cir. 2010)
  - Trustee could recover interests in LLC from post-petition transfer
  - All of the debtor's contractual rights in the LLC, both economic and management, became property of the estate upon filing, under § 541(a)(1)
- In re B & M Land & Livestock, LLC, 498 B.R. 262 (Bankr. D. Nev. 2013)
  - Trustee remained in control of the entire LLC, including both the economic and management rights
- In re Clark, 548 B.R. 246 (B.A.P. 9th Cir. 2016)
  - Assets of a single member LLC may be substantively consolidated into the debtor's estate

## LLC – Multi-Member

- In re Ehmman, 319 B.R. 200 (Bankr. D. Ariz. 2005)
  - The operating agreement was not an executory contract, therefore, § 541 governed the rights of the trustee
    - Court found the operating agreement was not executory because the debtor member did not have any remaining obligations
      - It held the only purpose of the LLC was to reduce estate tax liabilities
  - Trustee was entitled to both the economic and management rights associated with the debtor member's interest
- In re McSwain, No. 07-43338, 2011 WL 4706982 (Bankr. W.D. Wash. Oct. 6, 2011)
  - The operating agreement was found to be an executory contract; however, the plaintiff co-member waived dissociation provisions in the operating agreement via her treatment of the defendant debtor
    - Operating agreement was executory because it contained multiple, mutual obligations:
      - Debtor had on-going management obligations to the LLC
      - Debtor was obligated to vote on major decisions, initial member decisions, and disinterested decisions
      - Debtor was obligated to vote on and contribute mandatory additional capital
      - Debtor was affirmatively restrained from engaging in unauthorized transfers of his membership interests
  - Therefore, the DIP retained his economic and management rights

## Hypothetical Test – Ninth Circuit Approach

- In re Catapult Ent'mt, Inc., 165 F.3d 747 (9th Cir. 1999)
  - Trustee/DIP's authority to assume, assign, or reject executory contracts is limited by § 365(c)(1)
  - Interpreting the plain language of the statute, Ninth Circuit held a DIP may not assume an executory contract over a non-debtor's objection if applicable law would bar assignment to a hypothetical third party, even where the DIP has no intention of assigning the contract in question to any such third party



## Valuing Minority Member's Interest Upon Transfer

- Pursuant to § 363, the trustee/DIP may sell the assets of the member/partner debtor to satisfy claims
  - Value determination is a fact-driven analysis
  - There is no universal method to determine the value of the debtor member/partner's interest in the entity
- Two traditional discounts that must be considered:
  - Lack of marketability discount
  - Minority interest/lack of control discount

## Ninth Circuit Application

- Maughan v. Correria, 148 Cal. Rptr. 3d 593 (2012)
  - Court determined the fair market value of the stock shares in dispute, then apportioned the relevant shares to determine the pro rata value of each share
  - The court applied a minority discount to the pro rata value of the minority interest owned by the minority member
- Robblee v. Robblee, 68 Wash.App. 69 (1992)
  - Court refused to apply both the minority discount and the lack of marketability discount because the value to the minority party was no different than it would have been in the market

CONVERSION OF INDIVIDUAL CHAPTER 11 CASE TO CHAPTER 7

By: Cecilia Lee, Esq.

When Congress enacted Section 348(f) to the Bankruptcy Code in 1994, the split of authority regarding the rights of the chapter 7 trustee to the chapter 13 debtor's post-petition earnings was resolved in favor of the debtor.<sup>1</sup> In 2015, the Supreme Court resolved another split of authority over the effect of conversion from chapter 13 to chapter 7. In *Harris v. Viegelahn*, the Supreme Court held that the undistributed post-petition plan payments in the hands of the chapter 13 trustee were property of the debtor upon conversion to chapter 7.<sup>2</sup> The chapter 13 debtor's post-petition earnings upon conversion to chapter 7 are thus established as belonging solely to the debtor.

The fate of the individual chapter 11 debtor's post-petition earnings upon conversion remains the subject of dispute. Representative of one line of authority, the Ninth Circuit Bankruptcy Appellate Panel held in *In re Markosian*<sup>3</sup> that the chapter 11 debtor's bonus, earned during the chapter 11 case but not paid until conversion to chapter 7, belonged to the debtor and not to the chapter 7 trustee.

The Markosians filed a joint chapter 7 petition, which they then converted to a chapter 11.<sup>4</sup> When the debtors could not confirm a chapter 11 plan because Mrs. Markosian lost her job, the debtors re-converted to chapter 7.<sup>5</sup> One month after the re-conversion, the debtors received a bonus Mr. Markosian had earned while the chapter 11 case pending.<sup>6</sup>

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<sup>1</sup> 11 U.S.C. §348(f)(1) provides that except in instances of bad faith conversion, "when a case under chapter 13 of this title is converted to a case under another chapter under this title – (A) property of the estate in the converted case shall consist of property of the estate, as of the date of filing of the petition, that remains in the possession of or is under the control of the debtor on the date of conversion[.]" The split of authority is epitomized in *In re Lybrook*, 951 F.2d 136 (7<sup>th</sup> Cir. 1991) and *In re Bobroff*, 766 F.2d 797, 803 (3<sup>rd</sup> Cir. 1985).

<sup>2</sup> 135 S. Ct. 1829 (2015).

<sup>3</sup> 506 B.R. 273 (9<sup>th</sup> Cir. BAP 2014).

<sup>4</sup> *Id.* at 274.

<sup>5</sup> *Id.*

<sup>6</sup> *Id.*

Following *In re Evans*,<sup>7</sup> the Bankruptcy Court held that the bonus belonged to the debtors.<sup>8</sup> In affirming this result, the Bankruptcy Appellate Panel relied on the statutory definition of property of the estate under Section 541(a) as distinct from property of the debtor under section 541(a)(6).<sup>9</sup> Specifically, Section 541(a)(6) excludes the chapter 7 debtor's post-petition earnings from personal services from property of the estate. In 2005, Congress added Section 1115(b) to the Bankruptcy Code, which provides that the post-petition earnings of the individual chapter 11 debtor are property of the chapter 11 estate.<sup>10</sup> Notably, the Bankruptcy Court held that the bonus was property of the chapter 11 estate pursuant to Section 1115(a)(2), which was not challenged on appeal.<sup>11</sup> The Bankruptcy Appellate Panel reasoned that Section 1115 does not apply upon conversion; rather, Section 348 applies.<sup>12</sup> Noting that Section 348(f) applies only to conversions from chapter 13 to chapter 7, the Markosian court relied on the language in Section 348(a):

Conversion of a case from a case under one chapter of this title to a case under another chapter of this title constitutes an order for relief under the chapter to which the case is converted, but, except as provided in subsections (b) and (c) of this section, does not effect a change in the date of the filing of the petition, the commencement of the case, or the order for relief.

Thus, the Court reasoned that property of the estate is determined as of the petition date, not the conversion date, which summons the exclusion under Section 541(a)(6) of earnings from personal services.<sup>13</sup> Hence, income from personal services that became property of the chapter

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<sup>7</sup> 464 B.R. 429 (Bankr. D. Colo. 2011).

<sup>8</sup> 506 B.R. at 275.

<sup>9</sup> 11 U.S.C. §541(a)(6) excludes from property of the estate “earnings from services performed by an individual debtor after the commencement of the case.”

<sup>10</sup> 11 U.S.C. §1115(b) includes as property of the estate “earnings from services performed by the debtor after the commencement of the case but before the case is closed, dismissed, or converted to a case under chapter 7, 12, or 13, whichever occurs first.”

<sup>11</sup> 506 B.R. at 275.

<sup>12</sup> *Id.* at 276.

<sup>13</sup> *Id.*

11 estate by operation of Section 1115(a)(2) is recharacterized as excluded from property of the estate by Section 541(a)(6) upon conversion and the provisions of Section 348(a).

The *Markosian* Court distinguished cases that rely on the similarity between Section 1306<sup>14</sup> and Section 1115 and the failure of Section 348(f)(1)(A) to mention chapter 11 as signifying Congressional intent to capture Section 1115 property as property of the converted chapter 7 case. See *In re Tolkin*,<sup>15</sup> and *In re Hoyle*.<sup>16</sup> The *Markosian* Court noted that Section 348(a) is not mentioned in this statutory interpretation, and further cited rules of construction that render the *Tolkin* reasoning faulty. Finally, the Court relied on Ninth Circuit and Supreme Court law that discourages legislative silence as a basis for statutory interpretation.<sup>17</sup>

*Markosian* has drawn criticism from courts in the Seven Circuit. In *In re Meier*,<sup>18</sup> the Bankruptcy Court criticized *Markosian's* reasoning that when Congress enacted Section 1115(a)(2), there was no need to amend Section 348(f) further because Section 348(a) is the controlling statute. The *Meier* lower court relied on *In re Lybrook*,<sup>19</sup> a 1991 case in which the Seventh Circuit held that the chapter 13 post-petition earnings belong to the chapter 7 estate upon conversion. Despite the fact that this outcome was legislatively overruled by enactment of Section 348(f) in 1994, the *Meier* Court held that the reasoning of *Lybrook* applies, stating, “[i]f Congress meant to reject the rule in *Lybrook* generally instead of only in chapter 13, it could have done so. Instead, there is an express statutory command that rejects the *Lybrook* rule for conversions from Chapter 13. §348(f)(1).”<sup>20</sup> On this basis, the Court held that *Lybrook's* interpretation of Section 348(a)(1) remains the law in the Seventh Circuit.<sup>21</sup>

<sup>14</sup> 11 U.S.C. §1306(a)(2) provides that the chapter 13 estate includes “earnings from services performed by the debtor after the commencement of the case, but before the case is closed, dismissed, or converted to a case under chapter 7, 11, or 12 of this title, whichever occurs first.”

<sup>15</sup> 2011 WL 1302191 (Bankr. E.D.N.Y. 2011).

<sup>16</sup> 2013 WL 329427 (Bankr. D. Idaho 2013).

<sup>17</sup> *Id.* at 277, citing *Polar Bear Prod. Inc. v. Timex Corp.*, 348 F.3d 700, 717 (9<sup>th</sup> Cir. 2004); *Brown v. Garner*, 513 U.S. 115, 121, 115 S. Ct. 552, 130 L. Ed. 2d 462 (1994).

<sup>18</sup> 528 B.R. 162, 165 (Bankr. N.D. Ill. 2015).

<sup>19</sup> 951 F.2d 136 (7<sup>th</sup> Cir. 1991).

<sup>20</sup> *Id.* at 165.

<sup>21</sup> *Id.*

On appeal, the District Court endorsed this result, holding that in the absence of a specific statute, it was bound to follow *Lybrook*.<sup>22</sup> The Court noted that Section 348(a) is the portion of the Bankruptcy Code that addresses the effect of conversion, but continued that “it must be mindful of §348(f).”<sup>23</sup> Reasoning that Section 348(a) is less specific than Section 348(f), the Court found that the latter expressly provides for the effect of conversion on post-petition earnings in the context of chapter 13, which the Court acknowledged was not at issue in the case. The Court rejected the argument that Section 348(a) is the general rule that applies in chapter 11 conversion to chapter 7 and that Section 348(f)(1) applies only to chapter 13 conversion.<sup>24</sup> Instead, the Court examined the history of the enactment of Section 348(f), noting that

“Congress sided with cases like *Bobroff*, but was careful to add a safety valve for the types of situations that the Seventh Circuit was worried about in *Lybrook* [that the downside risk is shifted to creditors upon conversion from chapter 13 and all potential upside is with the debtors]. Thus, Congress’s solution to the circuit split was not to reject *Lybrook*’s interpretation of Section 348(a) as incorrect, but to create an entirely new provision that set out the preferred result and provided a remedy for conversions performed in bad faith.”<sup>25</sup>

The District Court criticized *Markosian* on the basis that nothing in Section 348(a) indicates that Section 348(f) is merely a clarification for chapter 13, and Section 348(f) makes no mention of the general rule in subpart (a).<sup>26</sup>

The Court in *In re Gorniak* cited the Bankruptcy Court decision Meier with approval for the proposition that the court is bound to follow *Lybrook*.<sup>27</sup> *Gorniak* was not appealed and has not been cited by other courts as of the time of submission of these materials for publication. The opposing views and results of these Courts suggest that a split of authority is developing on

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<sup>22</sup> 550 B.R. 384, 387 (N.D. Ill. 2016).

<sup>23</sup> *Id.*

<sup>24</sup> *Id.*

<sup>25</sup> *Id.* at 389.

<sup>26</sup> *Id.* at 377.

<sup>27</sup> 549 B.R. 721, 723-24 (Bankr. W.D. Wisc. April 8, 2016).

the fate of post-petition earnings from personal services in a chapter 11 case to a chapter 7 case that may be need resolution by Congress or the Supreme Court.

**American Bankruptcy Institute: Winter Leadership Consumer Panel**

**VALUATION OF A DEBTOR’S INTEREST IN LIMITED LIABILITY BUSINESS ENTITIES – A NINTH  
CIRCUIT APPROACH**

Robert P. Reynolds<sup>1</sup>

**I. Introduction**

Today, individual business related bankruptcies are relatively common. In these types of cases, difficult valuation questions can arise. This is particularly true when the debtor is a member of an LLC or a general partner in an LLP. Are the economic and management rights of members/general partners included as assets in the debtor’s estate? Do management rights transfer to a Chapter 7 trustee or a Chapter 11 debtor-in-possession? These questions result in an interesting analysis considering state statutes, corporate case law, and the federal Bankruptcy Code.

This paper will provide a general overview of the valuation process for a member/general partner debtor of both LLCs and LLPs. First, the paper provides a general outline of LLC and LLP law, including the respective default provisions governing a member/general partner’s filing of bankruptcy. Second, the paper will address the typical valuation process under 11 U.S.C. § 541. Third, the paper will explore the deference afforded to LLC operating agreements and LLP partnership agreements under 11 U.S.C. § 365, noting the potential variations in judicial interpretation. Fourth, the paper address the differences in application in Ninth Circuit cases, based upon the degree of a debtor’s ownership interest in the LLC or LLP. Fifth, the paper will note the similarities in valuation of member/general partner debtor’s assets in both LLCs and LLPs. Finally, the paper will conclude by examining valuation conflicts in practice by examining the potential discounts that will be applied when determining the value of a minority member or partner’s

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interest, so that the trustee or debtor in possession may receive the maximum value for their interest in the entity.

## **II. Limited Liability Companies**

LLCs are business entities formed by one or more persons, and were originally created to provide tax benefits similar to those afforded to partnerships and limited liability protections, similar to corporations. LLCs are formed pursuant to state law, and are typically required to be registered or be filed with the Secretary of State or similar agency. Each party with an interest in an LLC is considered a member.

LLCs have increased in popularity tenfold over the past three decades. Unfortunately, the Bankruptcy Code has not evolved at an equally rapid pace. Accordingly, while the LLC has been a successful business entity form for roughly twenty years, it still bears no mention in the Bankruptcy Code. The Code does not define an LLC, therefore, questions often arise as to whether an LLC should be treated as a corporation or as a partnership under the Code. This lack of clarity presents multiple issues, especially when individual debtors own assets that include membership interests in LLCs and bankruptcy courts must determine the total value the debtor's interest. Valuation of a member's interest is further complicated when the interest is separated into two parts: (1) the economic interests – the right to share in profits and losses of the LLC and the right to receive distributions; and (2) the noneconomic rights, such as the right to vote (including the determination of the amount of any distributions), participate in management, and receive information regarding the affairs of the LLCs. Ultimately, bankruptcy courts must analyze governing state law, the LLC's operating agreement, and the Code to determine the proper valuation of the debtor member's interest in the LLC.

Moreover, the distribution of membership interests in an LLC result in different valuations depending on the number of members and allocation of membership “shares.” A multi-member LLC, whether member or manager managed, has multiple individuals or entities with membership interests in the LLC. “Because such LLCs are closely held, and the members have important managerial duties and powerful voting rights...state statutes have traditionally restricted transferability, assignability or alienability of the interests of one member.” “These restrictions are either statutorily based or set forth in the LLC’s operating agreement, and usually require unanimous or majority consent of the remaining members to approve the transfer of the transferring member’s interest.” LLC’s can require transfer approval by a specific percentage of members or membership interests. In single member LLCs, however, state statutes do not typically address the rights of the sole member, but “some case law suggests that restrictions on transferring a membership interest in an LLC do not apply to single member LLCs.” In order to provide consistent statutory examples, this paper will utilize the California Corporations Code as a statutory default in its examination of valuation determinations in both reorganization and liquidation cases.

### **III. Limited Liability Partnerships and General Partnerships**

Unlike relatively new LLCs, limited liability partnerships (LLPs) are essentially general partnerships with limited liability afforded to the limited partners. They have both historic roots and are statutorily defined. Like partnerships, LLPs are formed when individuals come together as partners in a business enterprise for profit. Unlike partnerships, however, in order to receive the benefits of limited liability, LLPs must register their entity status according to governing state law. For example, in California, a LLP must register with the Secretary of State in order to receive legal recognition as an LLP. LLP membership is made up of all general partners, or general partners

and limited partners. For the purposes of this paper, we will focus solely on LLP general partners, as limited partners generally do not possess management rights. As noted above, this paper will focus on the effect a general partner's bankruptcy can have on his or her interest in the LLP, including both their economic and management rights.

The use and prevalence of LLPs has rapidly evolved in the past thirty-five years. However, as noted above, the Bankruptcy Code has progressed at a lackluster pace. Many questions surrounding the intersection of LLP partnership agreements and the Bankruptcy Code remain unanswered. Accordingly, the valuation of general partner-debtor's assets has largely been left to judicial interpretation. Unlike LLCs, however, the Bankruptcy Code does specifically mention partnerships and partners, albeit briefly. For example, 11 U.S.C. §101(32)(B) specifically references partnership debtors in its definition of "insolvent;" §303(b)(3) delineates certain criteria as to who can file an involuntary petition against a partnership; §303(d) allows a general partner to controvert an involuntary petition against the partnership he/she is a member of; §502(a) permits a general partner of a Chapter 7 debtor partnership to object to proofs of claim filed against the partnership; §2058(b) states the consequences if a creditor of a partnership receives payment on its claim from a partner who is not the Chapter 7 debtor; §723 details the rights of a Chapter 7 trustee to require general partners to pay the partnership creditors; §§1141(d) and 1227(a) dictate that confirmed Chapter 11 and 12 plans are binding on the general partners of the debtor partnership; and finally, §1141(d) terminates the rights and interests of general partners after confirmation of the partnership debtor's Chapter 11 plan.<sup>2</sup>

While partnerships are contemplated by the Bankruptcy Code, there are several issues surrounding these business entities that the Code does not completely address. As previously

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<sup>2</sup> Sally S. Neely, *Partnerships and Partners and Limited Liability Companies and Members in Bankruptcy: Proposals for Reform*, 71 Am. Bankr. L.J. 271, 285 (1997).

mentioned, one of the main issues arises when a general partner files bankruptcy. The partner's economic and management rights are certainly included in the partner's assets under § 541, but the valuation and later distribution of these assets has triggered conflicting provisions of the Bankruptcy Code, as well as split decisions by the Circuit Courts. The Supreme Court recognized this Circuit Split in N.C.P. Marketing Group, Inc., where it denied cert., but it has yet to fully address whether the control of management rights is controlled by the LLP partnership agreement or if such pre-petition control is considered void under § 365 of the Bankruptcy Code.<sup>3</sup>

Thus, the valuation of a general partner-debtor's assets in an LLP varies by jurisdiction. Moreover, like multi member LLCs, the distribution of partnership interests results in different valuations depending ownership percentage. Thus while asset protections granted by statute and partnership agreements are generally upheld under the "hypothetical test," and the dominion of the bankruptcy estate is usually protected under the "actual test," outcomes under both tests may differ according to the debtor-partner's ownership percentage.

#### **IV. Valuation under 11 U.S.C. § 541**

After a member or general partner files his or her bankruptcy petition, the key issue for the non-bankrupt members of an LLC or LLP, as well as for the trustee (or debtor in possession), is whether the non-bankrupt members or partners have the right or obligation to operate or to dissolve the LLC or LLP, and how to value this right in accord with § 541 of the Bankruptcy Code.

Historically, the bankruptcy of an LLC member resulted in dissolution. Today, however, "most LLC statutes have been amended to afford LLCs the corporate attribute of perpetual

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<sup>3</sup> In re N.C.P. Mktg. Grp., Inc., 337 B.R. 230 (D. Nev. 2005), aff'd, 279 F. App'x 561 (9th Cir. 2008), *cert. denied*, N.C.P. Mktg. Grp., Inc. v. BG Star Prods., Inc., 556 U.S. 1145 (2009).

duration.”<sup>4</sup> Thus, “the bankruptcy of a member no longer causes an LLC to dissolve but rather it causes the member to dissociate from the LLC.”<sup>5</sup> “Case law defines dissociation to mean that a member has withdrawn, or is terminated, as a member of the LLC, either voluntarily or upon the occurrence of one or more predetermined events set forth in the operating agreement or applicable law.”<sup>6</sup> For example, the California Revised Uniform Limited Liability Company Act provides “a person is dissociated as a member from a limited liability company when... [i]n a member-managed limited liability company, the person becomes a debtor in bankruptcy.”<sup>7</sup> The LLC will continue its business uninterrupted but the debtor member is no longer a member and his or her membership rights terminate. The debtor member retains any of their transferable interests, however, such interest is owned by the member “solely as a transferee.”<sup>8</sup> Thus the debtor member retains his or her economic rights but loses the governance rights attendant to their membership interest. Though a debtor membership interest in the LLC is personal property, the nature of that property interest will determine the valuation of such interest in bankruptcy.

Similar to LLCs, the bankruptcy of a general partner has historically terminated that partner’s management rights in the LLP.<sup>9</sup> Under the Uniform Partnership Act (UPA), the bankruptcy of a partner in a partnership dissolved the partnership and the partner could not participate in the winding up of the business.<sup>10</sup> However, under the Revised Uniform Partnership Act (RUPA), dissolution is disfavored. Thus, under RUPA, which most states, including California have adopted in part or whole, bankruptcy dissociates the debtor-partner from the partnership,

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<sup>4</sup> Nicholas G. Karambelas, *Limited Liability Companies: Law, Practice and Forms*, 1 LTD. LIAB. CO.: L., PRAC., AND FORMS § 17:7 (2016).

<sup>5</sup> *Id.*

<sup>6</sup> Robert C. Furr & Jason S. Rigoli, *A Debtor’s Membership Interest in an LLC: What a Trustee Receives*, AM. BANKR. INST. J., Aug. 2012, at 38.

<sup>7</sup> Cal. Corp. Code § 17706.02.

<sup>8</sup> Cal. Corp. Code § 17706.03.

<sup>9</sup> See Unif. Partnership Act §§ 35(3)(b), 37; 6 U.L.A. 842, 865 (1995); Rev. Unif. Partnership Act §

<sup>10</sup> Neely, *supra* note 2, at 295; see also Unif. Partnership Act §§ 31(5), 37, 6 U.L.A. AT 73, 81-82, 92-93.

which can result in dissolution. If the other partners choose to continue the partnership, they are required to purchase the debtor-partner's interest.<sup>11</sup> Accordingly, dissolution of the partnership is no longer promised when a general partner files personal bankruptcy. While perhaps beneficial for the partnership, this result can pose a negative impact on the partner-debtor in his or her own personal bankruptcy case.

A clear conflict exists between state law, partnership agreements and the Bankruptcy Code. While state laws and partnership agreements are typically slanted towards the partnership as a whole, the Bankruptcy Code, especially Chapter 7, is designed to reallocate the debtor's assets to the estate, where the trustee will then liquidate these assets for distributions to creditors. The conflict arises when partnerships buy back economic interests, but do not include the price of management interests in their buyback.<sup>12</sup> Moreover, under §541(a), both economic and management rights are included as assets of the estate.

Section 541(a) defines "property of the estate" as "all legal or equitable interest of the debtor in property as of the commencement of the case...notwithstanding any provision in any agreement transfer instrument, or applicable nonbankruptcy law."<sup>13</sup> Under this provision, it is determined that a debtor's equity interest in an LLC or LLP becomes property of the bankruptcy estate upon the filing of the debtor's petition.<sup>14</sup> Though this language suggests all property of the debtor, including his or her membership and economic rights in an LLC or LLP, should be included in the estate, some sections of the Code, and other applicable state laws demonstrates otherwise.

Adhering to these Code provisions or state statutes can be disfavored in bankruptcy, as they can negatively affect the value of debtor estate and creating more difficulty in obtaining the

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<sup>11</sup> Neely, *supra* note 2 at 295; *see also* Rev. Unif. Partnership Act §§ 601(6)(i), 701, 801, 6 U.L.A. AT 842, 865.

<sup>12</sup> Neely, *supra* note 2 at \*f.n.168.

<sup>13</sup> 11. U.S.C. § 541(a)(1) (2012).

<sup>14</sup> *See below In re First Prot., Inc.*, 440 B.R. 821 (B.A.P. 9th Cir. 2010).

maximum value of such property interests. Thus, these provisions are generally precluded by the ipso facto clauses. Such clauses permit an agreement to end automatically because of a party's bankruptcy, insolvency, or financial condition. These provisions are often found in LLC operating agreements "providing for forfeiture, modification, or termination of a debtor's member's interest solely upon commencement of bankruptcy."<sup>15</sup> They are also found in state statutes, for example, under California law, "A person is dissociated from a limited partnership as a general partner upon the occurrence of any of the following events...the person's...becoming a debtor in bankruptcy."<sup>16</sup> Accordingly, while LLC members or LLP partners may have certain agreements prior to a member/partner-debtor filing bankruptcy, there are corresponding ipso facto clauses in the Code which may prevent the fruition of this agreement: §§ 541(c); 361(1); 365(e); 365(f)(1); and 365(f)(3). Therefore, courts must consider LLC and LLP agreements, relevant state law, and the ipso facto clauses in the Bankruptcy Code to determine what assets of a member/partner-debtor are assumed by the estate under § 541(a).

#### **V. 11 U.S.C. § 365**

If it is determined that the operating/partnership agreement is an executory contract, § 365 will govern the trustee's rights. "In that event, the restrictive provisions under [state law] or the operating agreement that affect the transfer of [the] [d]ebtor's interest may be enforced through the operation of § 365, in some instances."<sup>17</sup> Section 365 includes critical limitations on the trustee's right of assumption under § 541 and ipso facto clause invalidation; however, what those limitations are, and how they will be applied, remains the subject of judicial debate.<sup>18</sup> Pursuant to

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<sup>15</sup> MARK A. SARGENT & WALTER D. SCHWIDETZKY, LIMITED LIABILITY COMPANY HANDBOOK § 3:99 (West 2016).

<sup>16</sup> Cal. Corp. Code § 15906.03.

<sup>17</sup> In re McSwain, No. 07-43338, 2011 WL 4706982, at \*7 (Bankr. W.D. Wash. Oct. 6, 2011).

<sup>18</sup> Joshua R. Elias, *Limited Liability Company Interests as Property of a Debtor's Estate: Executory Agreements and the Conundrum of Section 365*, THE BUSINESS ADVISOR (Oct. 7, 2015), <http://gibbonslaw.com/limited-liability-company-interests-as-property-of-a-debtors-estate-br-executory-agreements-and-the-conundrum-of-section-365-10-07-2015>.

§ 365(a), subject to certain exceptions, “the trustee, subject to the court’s approval, may assume or reject any executory contract or unexpired lease of the debtor.”<sup>19</sup> Further, §§ 365(f) and (e)(1)

allow for free assignability of executory contracts, without regard to any contractual provision or applicable law that would prohibit assignment or alter the rights or obligations under the executory contract due to assignment, the financial condition of the debtor, the commencement of a bankruptcy case, or the appointment or taking possession by a trustee.<sup>20</sup>

Specifically, § 541(c) and § 365(e)(1) work in conjunction to override any restriction on the transferability of a membership interest by including such interest in the property of the estate and permitting the avoidance of ipso facto clauses “that would otherwise provide for the termination or modification of a contract or contract right that might be triggered by the debtor’s commencement of the case.”<sup>21</sup>

So, for an executory contract, i.e. the debtor’s membership interest in an LLC or LLP, to be beneficial to the estate, the trustee must be able to assume the contract and assign it a third party. However, as discussed *supra*, most operating agreements will “contain restrictions on transfers to third parties, and such restrictions may implicate dissociation provisions of such agreements.”<sup>22</sup> However, §§ 365(c)(1) and (e)(2) provide the crucial limitations that suggest bankruptcy courts may still enforce the restricting provisions in operating agreements that are triggered by a member or partner filing bankruptcy.

Sections “365(c)(1) and (e)(2) remove that freedom of assignment and revive those ipso facto clauses where applicable law permits the non-debtor from dealing with anyone but the debtor.”<sup>23</sup> Section 365(c)(1) provides that the trustee or debtor in possession may not assume or

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<sup>19</sup> 11 U.S.C. § 365(a) (2012).

<sup>20</sup> Elias, *supra* note 11.

<sup>21</sup> James J. Wheaton, *LLCS and Bankruptcy – A Case Law Update*, 64 CONSUMER FIN. L. Q. REP. 504, 512 (2010).

<sup>22</sup> Elias, *supra* note 11.

<sup>23</sup> Wheaton, *supra* note 14, at 512.

assign an executory contract if: (1) applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession, whether or not such contract or lease prohibits or restricts an assignment of rights or delegation of duties; and (2) such party does not consent to such assumption or assignment.<sup>24</sup> Section 365(e)(2) “exempts the same categories of executory contracts from the provisions cited above that would otherwise override ipso facto clauses.”<sup>25</sup> Therefore, “it would seem that at trustee... will not be permitted to assume an operating agreement if it can be determined that the agreement is of a type as to which state law excuses a non-bankrupt member from accepting performance from or rendering performance to any party other than the debtor or the debtor in possession.”<sup>26</sup>

Many courts have refused to attempt to reconcile the inconsistencies found in § 365. “The problem is with the repeated references to applicable law which seems to say the same thing in different ways.”<sup>27</sup> “The question is whether applicable law precludes a debtor, debtor in possession, or trustee from assuming or assigning an executory contract,” which has resulted in a circuit split.<sup>28</sup> The Ninth Circuit has “adopted the ‘hypothetical test,’ based on a literal interpretation of the statute, under which the court determines whether applicable law bars assignment to a hypothetical third party under the circumstances before the court.”<sup>29</sup> “The Ninth Circuit explained, in In re Catapult Entertainment, ‘[o]nly if the law prohibits assignment on the

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<sup>24</sup> 11 U.S.C. § 365(e)(1) (2012).

<sup>25</sup> Wheaton, *supra* note 14, at 513. *See also* 11 U.S.C. § 365(e)(2) (2012).

<sup>26</sup> *Id.*

<sup>27</sup> Elias, *supra* note 11.

<sup>28</sup> *Id.*

<sup>29</sup> *Id.*

rationale that the identity of the contracting party is material’ will an ipso facto clause be given effect under §§ 365(c)(1) and (e)(2).”<sup>30</sup>

Overall, “§ 365 contains confusing language... [i]t is both partially consistent with § 541(c)(1), and simultaneously inconsistent with § 541(c)(1).”<sup>31</sup> In short, depending on your jurisdiction, “ipso facto provisions such as dissociation clauses will be enforced as to noneconomic rights if “applicable law” excuses a party, other than the debtor, to an LLC agreement from accepting performance from or rendering performance to a party other than the debtor, and such third party does not consent to the trustee’s acquisition of the debtor’s interest.”<sup>32</sup>

## VI. Ninth Circuit Application

### a. Single Member LLCs

#### i. Introduction

Where the debtor is the sole member of a single-member LLC, the determination of the membership interest is relatively simple. The bankruptcy of a single member LLC in the Ninth Circuit will result in the trustee gaining both the membership and economic rights belonging to the sole member. The distinction between economic and management rights are not relevant, as the “trustee’s rights automatically include the right to manage entity.”<sup>33</sup> This treatment of membership interests illustrates Congress’ concern that limits on transfers of property would divest the estate of a property interest or contractual right.<sup>34</sup>

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<sup>30</sup> Elias, *supra* note 11; In re Catapult Ent’mt, Inc., 165 F.3d 747, 752 (9th Cir. 1999) See also Laura D. Steele, *Actual or Hypothetical: Determining the Proper Test for Trademark Licensee Rights in Bankruptcy*, 14 INTELL. PROP. L. REV. 411 (2010) (“In that case, a Chapter 11 debtor proposed to assume a patent license as part of its reorganization plan. The licensor objected. The court agreed with the licensor, holding that the debtor in-possession could not assume an executory contract over the licensor’s objection if applicable law would bar assignment to hypothetical third party, even where a debtor-in-possession has no intention of assigning the contract in question to any such third party.”)

<sup>31</sup> Lawrence A. Goldman, *Limited Liability Company Interests As Property of a Debtor’s Estate – Is the Operating Agreement Executory?*, BUS. L. TODAY, Jan. 2016 at 2.

<sup>32</sup> *Id.*

<sup>33</sup> SARGENT & SCHWIDETZKY, *supra* note 9.

<sup>34</sup> See BANKRUPTCY LAW MANUAL § 5:30 (5th ed. 2016).

ii. Case Law

**In re First Prot., Inc., 440 B.R. 821 (B.A.P. 9th Cir. 2010)**

In In re First Protection, Inc., the debtors were the sole owners of First Protection, Inc. and Redux Development, LLC, both Arizona corporations.<sup>35</sup> After filing an individual chapter 11 petition and First Protection's chapter 11 petition, the debtors transferred 50% of their interest in Redux to a non-debtor party. The cases were later converted to chapter 7 and the appointed trustee sought to avoid the post-petition transfer. The bankruptcy court ruled that the trustee could recover the transferred membership interest and the debtors appealed to the Ninth Circuit Bankruptcy Appellate Panel (BAP). The debtors argued the only thing of value held by the estate were the economic rights in Redux, not the management rights they formerly held. The court concluded "that all of Debtor's contractual rights and interests in Redux became property of the estate under § 541(a)(1) by operation of law when they filed their petition."<sup>36</sup> Holding, "[s]ection 541(c)(1)(A) overrides both contract and state law restrictions on the transfers or assignment of Debtor's interest in Redux in order to sweep all their interests into their estate," the court determined the restrictions under the operating agreement and the Arizona LLC Act "did not prevent the vesting of their contractual rights in the bankruptcy estate."<sup>37</sup> "As a result, the trustee was not a mere assignee, but stepped into Debtor's shoes, succeeding to all their rights, including the right to control Redux."<sup>38</sup>

**In re B & M Land & Livestock, LLC, 498 B.R. 262 (Bankr. D. Nev. 2013)**

In In re B & M Land and Livestock, LLC, a debtor holding the sole membership interest in an ordinary single member LLC filed a petition for bankruptcy under Chapter 7.<sup>39</sup> The debtor

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<sup>35</sup> In re First Prot., Inc., 440 B.R. 821 (B.A.P. 9th Cir. 2010).

<sup>36</sup> *Id.* at 830.

<sup>37</sup> *Id.*

<sup>38</sup> *Id.* Note, the court also considered In re Albright, 291 B.R. 538 (Bankr. D. Colo. 2003), reaching the same conclusion as the Albright court, although via different reasoning.

<sup>39</sup> In re B & M Land & Livestock, LLC, 498 B.R. 262 (Bankr. D. Nev. 2013).

argued state law governed whether a membership interest in an LLC constitutes a property interest. However, the bankruptcy court distinguished between the “rights that a trustee requires to administer the estate or that an estate acquires under § 541” and applicable state law, holding, “[w]here the bankruptcy estate in a Chapter 7 bankruptcy has a membership interest in a single-member LLC, the trustee controls the LLC.”<sup>40</sup> The B & M Court further held, “[a] conflicting state law provision, should any exist, would not compel a different outcome...§ 541 trumps any conflicting analysis or rules in state law relating to the control of LLCs.”<sup>41</sup> Note, however, this court found this principle to be limited when “the LLC is run by or deals with matters such as professional practices or personal services,” such as a “law firm, medical practice, or accounting firm organized as an LLC.”<sup>42</sup>

**In re Clark, 548 B.R. 246 (B.A.P. 9th Cir. 2016)**

A recent Ninth Circuit BAP case presents an interesting issue regarding single member LLCs and how the assets of such an LLC may be reachable by creditors. In In re Clark, a chapter 7 trustee filed an adversary complaint against Clark’s Crystal Springs Ranch LLC, and Clark Farms Family Trust, seeking a judgment consolidating the estate of the debtor with the LLC and its sole member, the Trust.<sup>43</sup> The trustee sought to recover and bring into the estate assets of the debtor held by the LLC. The debtor was the trustee of the family Trust and exercised total control over the LLC’s operations. Using the Bonham test, the bankruptcy court determined the evidence showed the creditors generally dealt with the debtor and the LLC as a single economic unit and that unraveling the financial affairs of the debtor, the LLC, and the Trust would be too difficult. Therefore, the bankruptcy court “concluded that substantive consolidation would benefit creditors

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<sup>40</sup> *Id.* at 266.

<sup>41</sup> *Id.* at 268.

<sup>42</sup> *Id.* at 267.

<sup>43</sup> In re Clark, 548 B.R. 246 (B.A.P. 9th Cir. 2016).

and far outweigh any potential harm.” The Ninth Circuit BAP affirmed the consolidation and confirmed the equitable powers of a bankruptcy court, notwithstanding the Supreme Court’s decision in Law v. Siegel.<sup>44</sup> This decision demonstrates an innovative manner where single member LLCs may be implicated in a bankruptcy case by a party other than their sole member.

**b. Multi Member LLCs**

**i. Introduction**

Though the property of the bankruptcy estate is still broadly defined to include both membership and economic rights, multi member LLCs introduce a more challenging analysis. First, a reviewing court will look to the entity’s operating agreement to determine what restrictions apply to the transfer or assignment of the debtor-member’s interest.<sup>45</sup> Typically, two provisions are most relevant: “(1) the provision under which a member is dissociated from the LLC upon the filing for bankruptcy; and (2) the provision placing restrictions on an interest held by an assignee/transferee.”<sup>46</sup> “The optimal result for the trustee would be for the debtor-member to become dissociated...and for the remaining members to be required to buy out the dissociated member’s interest. Then, “the estate would be entitled to the full value of the buyout, and the trustee would not have to...attempt to sell the interest in the LLC.”<sup>47</sup> Though the Ninth Circuit has established broad powers for the trustee in Chapter 7 cases pursuant to § 541(a)(1), LLC operating agreements are considered contracts under the Code, governed are by § 365. Further analysis of the extent of a debtor member’s interest in bankruptcy will depend on whether the operating agreement giving rise to the LLC is executory. “Section 365 authorizes the trustee to assume or

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<sup>44</sup> Law v. Siegel, 134 S. Ct. 1188 (2014).

<sup>45</sup> Furr & Rigoli, *supra* note 9. Additionally, if the operating agreement does not address the bankruptcy of a debtor member, the reviewing court will look to the statutory default for LLC governance.

<sup>46</sup> *Id.* at 40.

<sup>47</sup> *Id.*

reject only those contracts that are executory...thus courts must first determine whether a contract is executory before authorizing the trustee to assume or reject a contract.”<sup>48</sup> If the operating agreement is deemed to be executory, the trustee’s rights will be much more restricted due to § 365.

Though the determination of whether an operating agreement is executory is integral to the valuation of a debtor member’s continuing rights in their LLC membership interest, the Code does not define ‘executory contract.’ Thus, bankruptcy courts have employed the well-known Countryman test, developed by Professor Vern Countryman in 1973.<sup>49</sup> Pursuant to this test, an executory contract is “a contract under which the obligation of both the bankrupt and the other party are so far underperformed that the failure of either to complete performance of the other.”<sup>50</sup> Indeed, by including language like the Countryman definition in the Code, legislative history of § 365 “seems to reflect a view similar to the Countryman definition by stating that contracts are executory if “performance remains due to some extent on both sides.”<sup>51</sup> Under this definition, “a contract is executory only if substantial performance remains due on both sides.”<sup>52</sup> Therefore, an operating agreement demonstrating the existence of an executory contract will contain “multiple, mutual obligations between and among the parties.”<sup>53</sup> Examples of these obligations will include ongoing management obligations by the debtor member to the entity, obligations to vote on major decisions of the entity, mandatory contributions of capital, affirmative restraints from engaging in unauthorized transfers of membership interests, and restrictions on competing with the entity or disclosing its confidential information.<sup>54</sup>

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<sup>48</sup> JONATHAN P. FRIEDLAND, ET AL., COMMERCIAL BANKRUPTCY LITIGATION § 8:2 (West 2016).

<sup>49</sup> *Id.*

<sup>50</sup> *Id.* See also Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 Minn. L. Rev. 439, 469 (1973).

<sup>51</sup> *Id.* See also H.R. REP. NO. 95-595, at 347 (1978), reprinted in 1978 U.S.C.C.A.N. 5963, 6303.

<sup>52</sup> *Id.*

<sup>53</sup> *In re McSwain*, No. 07-43338, 2011 WL 4706982, at \*6 (Bankr. W.D. Wash. Oct. 6, 2011).

<sup>54</sup> *Id.*

Although this definition is commonly used to determine whether § 541 or § 365 will govern the trustee's rights, some bankruptcy judges have criticized Countryman.<sup>55</sup> For example, one Idaho bankruptcy court determined a real estate installment contract was executory under the Countryman definition but ultimately held the contract under which the debtor was the purchaser was not an executory contract.<sup>56</sup> This court reasoned "the Countryman definition would render almost all agreements executory since it is the rare contract...that does not encompass *some* unperformed obligations on each side... [therefore] "rote classifications of contracts...should be avoided."<sup>57</sup> The Heward court suggested, "the individual characteristics of each contract should be analyzed under the peculiar facts of each bankruptcy case in order to determine whether the contract is executory."<sup>58</sup>

## ii. Case Law

### In re Ehmann, 319 B.R. 200 (Bankr. D. Ariz. 2005)

Debtor owned a minority interest in Fiesta Investments, LLC, which was an Arizona LLC formed by the debtor's parents as an estate-planning vehicle.<sup>59</sup> The trustee filed suit seeking a declaration that the trustee had the status of a member in Fiesta and had acquired all of the debtor's "right, title, and interest pursuant to § 541(a).<sup>60</sup> Fiesta moved to dismiss relying on its operating agreement, arguing the trustee only held economic rights upon the acquisition of a member's interests. The court began by analyzing the Fiesta operating agreement to determine if the agreement was an executory contract under the Countryman test. The court noted that "Fiesta undoubtedly owe[d] many obligations to its members pursuant to the Operating Agreement, for

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<sup>55</sup> FRIEDLAND, ET AL., *supra* note 41.

<sup>56</sup> *Id.*

<sup>57</sup> In re Heward Bros., 210 B.R. 475, 478 (Bankr. D. Idaho 1997).

<sup>58</sup> *Id.* at 478.

<sup>59</sup> In re Ehmann, 319 B.R. 200 (Bankr. D. Ariz. 2005).

<sup>60</sup> *Id.* at 203.

the contract to be executory there would also have to be some material obligation owing to the company by the member...that if the member did not perform it, Fiesta would owe no further obligations to that member.”<sup>61</sup> The court continued with a close reading of Fiesta’s operating agreement to find “no obligations imposed on members that bear on the rights the Trustee seeks to assert, [thus] the Trustee’s rights are not controlled by the law of executory contracts and Bankruptcy Code § 365.”<sup>62</sup> Thus, the court held the trustee’s rights were governed by the “more general provision” of § 541.<sup>63</sup>

**In re McSwain, No. 07-43338, 2011 WL 4706982 (Bankr. W.D. Wash. Oct. 6, 2011).**

Plaintiff, a minority member of Hawks Prairie Casino, LLC, filed an adversary complaint for declaratory relief, seeking a judgment that defendant debtor no longer possessed any management rights in the LLC, and that his interest was solely that of an assignee under state law and the dissociation provisions of the LLC’s operating agreement.<sup>64</sup> Applying the Countryman test, the court determined provisions found in Hawks Prairie Casino, LLC, were “hallmarks of executory contracts for LLC agreements.”<sup>65</sup> The court agreed with dicta from In re First Protection concerning In re Catapult Entertainment, Inc. “where applicable nonbankruptcy law makes an executory contract non-assignable because the identity of the non-debtor party is material, a debtor in possession may not assume the contract absent consent of the non-debtor party.”<sup>66</sup> The Court read Catapult as

requiring three elements that must be met before a bankruptcy court may enforce dissociation provisions against an LLC member who files for bankruptcy: (1) the LLC agreement, must in fact, be an executory contract; (2) applicable nonbankruptcy law must forbid

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<sup>61</sup> *Id.* at 204.

<sup>62</sup> *Id.* at 206.

<sup>63</sup> *Id.*

<sup>64</sup> In re McSwain, No. 07-43338, 2011 WL 4706982 (Bankr. W.D. Wash. Oct. 6, 2011).

<sup>65</sup> *Id.* at \*7.

<sup>66</sup> *Id.* (citing In re Catapult Ent’mt, Inc., 165 F.3d 747, 752 (9th Cir. 1999)).

the contract's assignment; and (3) assignment must be forbidden because the identity of the non-debtor party is material.<sup>67</sup>

“To put it another way, First Protection's use of the phrase ‘some instances’ when discussing whether applicable law precludes assumption of an LLC operating agreement should be interpreted to mean instances in which all three Catapult elements are present.”<sup>68</sup> The court found that the operating agreement in question easily met the first two elements. However, the court found that even assuming the identities of the other members are not material, such that the debtor could assume the agreement, the plaintiff's waiver of her right to enforce the dissociation provisions moots the necessity of ruling on the matter.<sup>69</sup> Thus, the court found the plaintiff had waived her right to enforce the dissociation provisions by treating the debtor as a full member for more than nineteen months. Under Washington law and the operating agreement, the debtor was entitled to exercise his full management and other membership rights.

**c. LLPs**

**i. Introduction**

As noted above, the ipso-facto clauses included in the Bankruptcy Code can render contractual or statutory provisions that modify or terminate the rights of a debtor-partner based on bankruptcy or financial condition ineffective. Pre-petition contracts, such as partnership agreements, may survive §541 via §365(a), but this determination is generally dependent on which judicial test, the “hypothetical test” or the “actual test, is applied. As the Circuits are split, the effect of pre-petition executory contracts and their effect on the debtor's estate is largely determined by jurisdiction. As noted above, the Supreme Court has recognized this issue, but it has yet to determine which test, if either, should be used to determine the effect of pre-petition

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<sup>67</sup> *Id.*

<sup>68</sup> *Id.*

<sup>69</sup> *Id.*

contracts the debtor engages in.<sup>70</sup> As the Ninth Circuit follows the “hypothetical test,” it is described in detail below, followed by case law discussing the effect of the “hypothetical test” on the valuation sale of such assets under § 363.

**ii. Hypothetical Test—Ninth Circuit**

**In re Catapult Entm't, Inc., 165 F.3d 747 (9th Cir. 1999)**

Catapult Entertainment, Inc. entered into two license agreements with Appellant Pearlman, which included the right to exploit relevant technologies, including patents and patent applications, two years prior to filing bankruptcy.<sup>71</sup> Catapult later filed for reorganization under Chapter 11 of the Bankruptcy Code,<sup>72</sup> and the relevant third party creditors and equity holders accepted Catapult’s reorganization plan by the requisite majorities required by the Bankruptcy Code.<sup>73</sup> As part of its reorganization plan, Catapult filed a motion seeking the assumption of roughly 140 executory contracts, including the Pearlman licenses. Pearlman objected to this assumption, but the bankruptcy court granted Catapult’s motion and approved its reorganization plan.<sup>74</sup> Under §365(a) & (f), the trustee (chapter 7) or debtor in possession (chapter 11) has the authority to “assume, assign or reject the executory contracts and unexpired leases of the debtor, notwithstanding any contrary provisions appearing in any contracts or leases.”<sup>75</sup> However, the Ninth Circuit made clear this authority is not absolute, holding instead that it is restricted by §365(c)(1), “the proper interpretation [of which] has been the subject of considerable disagreement among courts and commentators.”<sup>76</sup> The court noted that on “one side [are] those who adhere to the plain statutory language, which establishes a so-called “hypothetical test” to

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<sup>70</sup> See, *supra* note 3.

<sup>71</sup> In re Catapult Entm't, Inc., 165 F. 3d 747, 748 (9th Cir. 1999).

<sup>72</sup> *Id.* at 749.

<sup>73</sup> *Id.*

<sup>74</sup> *Id.*

<sup>75</sup> *Id.*

<sup>76</sup> *Id.*

govern the assumption of executory contracts,”<sup>77</sup> and “[o]n the other side are those that forsake the statutory language in favor of an “actual test” that, in their view, better accomplishes the intent of Congress.”<sup>78</sup> Unsurprisingly, the court adopted the “hypothetical test.”<sup>79</sup>

Under this test, the court found that as federal patent law makes nonexclusive patent licenses personal and non-delegable, §365(c)(1)(A) is satisfied [and, as] Perlman has withheld his consent, §365(c)(1)(B) is satisfied. Accordingly, the Court determined that the plain language of §365(c)(1) bared Catapult from assuming the Perlman licenses.<sup>80</sup> The court further explained its rationale stating: “the statute by its terms bars a debtor in possession from *assuming* an executory contract without the non-debtor’s consent where applicable law precludes *assignment* of a contract to a third party.”<sup>81</sup> Accordingly, the court noted the following language establishes a hypothetical test: “a debtor in possession may not assume an executory contract over the non-debtor’s objection if applicable law would bar assignment to a hypothetical third party, even where the debtor in possession has no intention of assigning the contract in question to any such third party.”<sup>82</sup> Thus, under the “hypothetical test,” it may be said that the Ninth Circuit gives more weight to the interests of third parties, than of the potential asset value gained through the assumption of executory contracts. This treatment of executory contracts is critical to understanding the valuation of the estate, and later, the sale of assets under § 363.

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<sup>77</sup> *Id.* (citing In re James Cable Partners, 27 F.3d 534,537 (11th Cir.1994); In re West Elec., Inc., 852 F.2d 79, 83 (3d Cir. 1988); In re Cantron, 158 B.R. 629, 633-38 (E.D.Va.1993) *aff’d without op.*, 25 F.3d 1038 (4th Cir.1994)).

<sup>78</sup> *Id.* (citing Institute Pasteur v. Cambridge Biotech Corp., 104 F.3d 489,493 (1st Cir.1997) *cert. denied*, 521 U.S. 1120 (1997)).

<sup>79</sup> *Id.* at 750.

<sup>80</sup> *Id.* at 750-51.

<sup>81</sup> *Id.* at 750.

<sup>82</sup> *Id.*

## VII. Valuation of Minority Member’s Interests Upon Transfer

### a. Minority Interest and Marketability Discount

As noted above, § 541 transfers all assets of the debtor to the chapter 7 trustee or the chapter 11 debtor-in-possession. Accordingly, under § 363, the trustee and debtor-in-possession have the authority to sell such assets to pay off secured and unsecured creditors.<sup>83</sup> In the process of selling assets, the issue of the ‘value’ of the assets is pertinent. Generally this is a fact-driven analysis, but this is an especially arduous task for courts when attempting to determine the value of membership/partnership interests in LLCs and LLPs. This analysis is further complicated because valuation is governed by state law, which “may differ with respect to the relevant factors that should be taken into account in conducting the pertinent valuation.”<sup>84</sup>

Though debtor members in an LLC or debtor partners in an LLP may hope bankruptcy courts will determine an equitable way to value their interest, “there is no single or universal method to determine [the] fair value of shares in a [closely held entity].”<sup>85</sup> Furthermore, neither the California Revised Uniform Limited Liability Company Act nor the California Uniform Limited Partnership Act define ‘fair market value.’<sup>86</sup> For example, the Uniform Limited Partnership Act provides, “[i]f the fair market value of the dissenting interest is in issue, the court shall determine, or shall appoint one or more impartial appraisers to determine, the fair market value of the dissenting interest.”<sup>87</sup> Therefore, this undefined valuation standard “creates a

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<sup>83</sup> 11 U.S.C. § 363 (2012).

<sup>84</sup> Stephen J. Leacock, *Lack of Marketability and Minority Discounts in Valuing Close Corporation Stock: Elusiveness and Judicial Synchrony in Pursuit of Equitable Consensus*, 7 WM. & MARY BUS. L REV. 683, 690 (2016). *See also* Voeller v. Neilston Warehouse Co., 311 U.S. 531, 535 (1941) [T]he conditions under which corporations shall organize and operate are matters within the exclusive province of the state, so long as those conditions do not clash with the national Constitution.”

<sup>85</sup> Torres v. Schripps, Inc., 776 A.2d 915, 924 (N.J. Super. Ct. App. Div. 2001).

<sup>86</sup> *See* Cal. Corp. Code § 17711.06; Cal. Corp. Code § 15911.25.

<sup>87</sup> § 15911.25.

potentially thorny situation when courts are called upon to...valu[e] a minority shareholder's stock in any specific close corporation valuation controversy.”<sup>88</sup>

In order to determine a minority member's or partner's interest in an LLC or LLP, it is first necessary to determine the value of the business as a whole and “then tak[e] into account the traditional types of discounts.”<sup>89</sup> These traditional types of discounts include the minority interest discount and the lack of marketability discount. “The legal justification for an appropriate discount is rational in order to account for the objectively recognizable vulnerabilities that an acquirer of a minority block of shares would find to be substantively unattractive.”<sup>90</sup> These discounts are applied to the value of the minority interest “in recognition of the theory that the lack of control and lack of a ready market reduces the market price which a hypothetical buyer would pay for such an interest.”<sup>91</sup>

Because of the lack of control and the lack of a ready market, potential purchasers of these debtor member's/partner's interests are particularly vulnerable. “The existence of these vulnerabilities supports the view that, prior to such a purchase, it is both fair and just to discount the value of the minority [interest] that the party is about to purchase.”<sup>92</sup> Furthermore, combined, these discounts can be quite substantial, often reducing the undiscounted value 20-50 percent.<sup>93</sup> Thus, “judicial scrutiny properly recognizes the rights of minority [interests] to a fair and just determination of the value of shares that they relinquish.”<sup>94</sup> Note, though these discounts will be

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<sup>88</sup> Leacock, *supra* note 84, at 688-89.

<sup>89</sup> Edwin T. Hood, John J. Mylan, & Timothy P. O'Sullivan, *Valuation of Closely Held Business Interests*, 65 UMKC L. Rev. 399, 448 (Spring 1997) [hereinafter Hood, et. al.]

<sup>90</sup> Leacock, *supra* note 84, at 695.

<sup>91</sup> Hood, et al., *supra* note 89, at 449.

<sup>92</sup> Leacock, *supra* note 84, at 695.

<sup>93</sup> Hood, et al., *supra* note 89, at 448 (citing Alan Halperin, *Dr. Jekyll and Mr. Hyde: The IRS States that Final Anti-Abuse Regulation Does not Apply to Family Limited Liability Partnerships, But What is Next?*, 20 TAX MGMT. 151, 153 (1995).

<sup>94</sup> Leacock, *supra* note 84, at 694 (citing *U.S. Bank N.A. v. Cold Spring Granite Co.*, 802 N.W.2d 363, 382-83 (Minn. 2011).

applied to determine the value of a minority interest, “courts will not permit a majority stockholder’s or a corporation’s devaluation of a minority stockholder’s shares by using lack of control discounts and lack of marketability discounts...proceed[e] to acquire the minority shareholder’s stock at that devalued price” because “this conduct would be unequitable and therefore unconscionable.”<sup>95</sup>

The first applicable discount to be applied is the minority interest discount. This discount, also known as a lack of control discount, “may be applied by the courts as a more valid tool to attain fairness and equity.”<sup>96</sup> The minority interest discount “adjust[s] for lack of control over the business entity on the theory that non-controlling shares of stock are not worth their proportionate share of the firm’s value because they lack voting power to control corporate actions.”<sup>97</sup> Because the interest being valued lacks control in the entity, its value is inherently reduced.<sup>98</sup> The critical factor of the minority interest discount, lack of control, “contains several components, including the lack of managerial control and inability to compel a sale of liquidation of the...assets.”<sup>99</sup> Naturally, when a member or partner lacks the management ability to compel payments, dissolution, or liquidation, the interest is no longer worth its book value. For example, if A, B, C, & D were all equal owners/partners in an LLP, each partner would have a 25 percent interest. Accordingly, if the LLP was valued at \$100, each partner’s interest would be worth \$25. No buyer, however, should pay \$25 for this interest, as it is a minority interest. If D’s interest is sold, the buyer would potentially become a partner in an LLP or member in an LLC where he has no ability to control its management. The right of control is the critical

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<sup>95</sup> *Id.* at 701-02.

<sup>96</sup> *Id.* at 688.

<sup>97</sup> *Id.*

<sup>98</sup> Hood, et al., *supra* note 89, at 449.

<sup>99</sup> *Id.*

element in determining a minority discount, and courts have assessed minority discounts up to 35 percent.<sup>100</sup>

Lack of marketability is another discount that can be added to a member/partner's interest in an LLC or LLP. Moreover, this discount may be noted in addition to the minority interest discount because the two discounts "are based on different concepts and should be treated independently of each other."<sup>101</sup> A lack of marketability discount "adjusts for a lack of liquidity in [a shareholder's] interest in an entity, on the theory that there is a limited supply of potential buyers in a closely-held corporation."<sup>102</sup> The rationale behind this discount is that unlike publicly traded businesses, there is no readily available market to sell private interests in limited liability entities; therefore, the purchasing party will be unable to quickly convert his or her interests into cash or other property.<sup>103</sup> Furthermore, this discount reflects "the lack of a public market on which the [interest] can be sold."<sup>104</sup> Thus, this discount is applied in two different situations: (1) when no ready market exists for an interest in a closely held partnership or LLC and (2) when a partner does not have the ability to liquidate their interest without the consent of other partners.<sup>105</sup>

#### **b. Case Law**

The following cases illustrate the application of the minority and marketability discount by courts the Ninth Circuit. Those these cases are not bankruptcy court decisions, they illustrate the spectrum of the potential discounts and their use.

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<sup>100</sup> *Id.* at 449 (citing *Moore v. Commissioner*, 62 T.C.M. (CCH) 1128, 1128 (1991)).

<sup>101</sup> *Id.*

<sup>102</sup> Leacock, *supra* note 84, at 688.

<sup>103</sup> Hood, et al., *supra* note 89, at 449.

<sup>104</sup> Douglas A. Cooper, *Closely Held Corporate Shares Require a Discount*, NEW YORK LAW JOURNAL (Apr. 19, 2010), [http://rmfpc.com/wp-content/uploads/2008/07/Litigation\\_HeldCorporateSharesAssets.pdf](http://rmfpc.com/wp-content/uploads/2008/07/Litigation_HeldCorporateSharesAssets.pdf).

<sup>105</sup> Hood, et al., *supra* note 89, at 450, 452.

**Maughan v. Correia, 148 Cal. Rptr. 3d 593 (2012)**

In Maughan v. Correia, the validity of an alleged stock option agreement to acquire a minority block of stock in a close, family run corporation came before the California Court of Appeal for resolution.<sup>106</sup> Though this case does not concern the valuation of a minority member or partner’s membership interest, the court defines fair market value, applies the applicable discounts to determine the fair market value, and provides procedural background for the application of the discounts. The trial court determined that “application of a minority discount was required in order to properly ascertain the fair market value of the stock to which the asserted stock option agreement applied.”<sup>107</sup> Once the overall value of the corporation was determined, “it is then apportioned to the relevant shares in order to arrive at the pro rata value of each share.”<sup>108</sup> The court then applied a second valuation, deducting the minority discount from that pro rata value.<sup>109</sup> Thus, the value remaining after this second deduction represented the court-determined appraisal of the minority stockholder’s shares in the close corporation.<sup>110</sup>

**Robblee v. Robblee, 68 Wash.App. 69 (1992)**

In Robblee v. Robblee, a closely held corporation and its majority shareholder and partnership and its controlling partner brought actions seeking division of assets pursuant to a letter of intent entered by the parties during mediation.<sup>111</sup> Of the closely held corporation, each party held 51 percent and 29.56 percent of the outstanding common stock and both were directors.<sup>112</sup> However, both parties were equal partners in the partnership.<sup>113</sup> Pursuant to the letter of intent, the

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<sup>106</sup> Leacock, *supra* note 84, at 696 (citing 148 Cal. Rptr. 3d 593, 602 (2012)).

<sup>107</sup> *Id.*

<sup>108</sup> Maughan, 148 Cal. Rptr. 3d at 603-04.

<sup>109</sup> *Id.*

<sup>110</sup> *Id.*

<sup>111</sup> Robblee v. Robblee, 68 Wash.App. 69, 69 (1992).

<sup>112</sup> *Id.* at 70.

<sup>113</sup> *Id.*

parties were to determine the difference in value between one's interest in the corporation and the other's interest in the partnership; then, the parties would acquire a third company with a value equal to that difference in value.<sup>114</sup> The third company and the interest in the partnership would be transferred to the other party, in exchange for that party's interest in the corporation. Thus, one party would get all the stock in the corporation and the other would get all of the partnership, plus the third company.<sup>115</sup>

The lower court applied a fair market minority discount to the shares belonging to the minority shareholder of the corporation and the minority holder appealed. He argued he was an oppressed minority shareholder at whose expense the oppressive majority shareholder should not benefit, or he was in effect a dissenting shareholder, to which no fair market discount applies, under state corporation law.<sup>116</sup> The court addressed both of these arguments and found the first to be without merit; however, the court agreed with the minority shareholder that he was in effect a dissenting shareholder and determined a discount should not have been applied. The court focused on the inherent "unfairness of discounting minority share's where the sale is to other shareholders."<sup>117</sup> Further, the court concluded, "had the value of the [minority] shares to a third party been at stake, it would have been appropriate for the trial court to apply a minority discount to approximate the fair market value."<sup>118</sup> The court determined that the shares should not be discounted, because the value to the other party is different than it would be in the market.<sup>119</sup> Refusing to apply neither the minority interest nor marketability discount, the court determined no

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<sup>114</sup> *Id.* at 71.

<sup>115</sup> *Id.*

<sup>116</sup> *Id.* at 75.

<sup>117</sup> *Id.* at 78.

<sup>118</sup> *Id.* at 80.

<sup>119</sup> *Id.*

market was involved in valuing the shares, thus there was no justification for the application of the discount.<sup>120</sup>

### **VIII. Conclusion**

The valuation process for the interests of a member in an LLC or general partner in an LLP, regardless of majority or minority status, presents many obstacles in the bankruptcy arena. The goal of this paper was to provide a brief, yet informative overview of the challenges bankruptcy practitioners will face with valuation of limited liability entities, especially in the context of transfer when the debtor member or partner holds a minority interest. Though the resolution of these issues largely depends on state law and the governing documents of the entities, bankruptcy law will continue to present unique challenges to the process of valuation.

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<sup>120</sup> *Id.*

# EXEMPTIONS

**American Bankruptcy Institute  
Winter Leadership Conference  
Rancho Palos Verdes, California  
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EXEMPTIONS

I. THE APPLICABLE STATUTORY SECTIONS AND RULES

A. 11 U.S.C.A. § 541(a)(1)

“The commencement of a case under sections 301, 302, or 303 of this title creates an estate. Such estate is comprised of all the following property, wherever located and by whomever held . . . (1) Except as provided in subsections (b) and (c)(2) of this section, all legal or equitable interests of the debtor in property as of the commencement of the case.”

The definition of property of the estate is broad. It covers almost anything in which the debtor has a legal or equitable interest.

B. 11 U.S.C.A. § 522(b)(1)

“Notwithstanding section 541 of this title, an individual debtor may exempt from property of the estate the property listed in either paragraph (2) or, in the alternative, paragraph (3) of this subsection.”

In other words, the debtor may use either state or federal exemptions.

C. 11 U.S.C.A. § 522(b)(2) provides the debtor with the right to use the federal exemption scheme “unless the State law that is applicable to the debtor under paragraph (3)(A) specifically does not so authorize.”

In other words, the state may prevent its citizens from using the federal exemption scheme set forth in § 522(d), and virtually all of them have done so.

D. 11 U.S.C.A. § 522(b)(3) allows the debtor to exempt any property that is exempt under federal law other than § 522(d) or state or local law that is applicable on the date of the filing of the petition.

In other words, the debtor may claim state exemptions and exemptions under other federal statutes. In addition, the debtor may claim certain property the debtor held in entireties, and (since BAPCPA) most retirement funds.

E. Fed. R. Bankr. P. 4003(a) mandates that the debtor list the claimed exemptions on Schedule C, Property Claimed as Exempt, pursuant to Fed. R. Bank. P. 1007(b)(1).

F. Fed. R. Bankr. P. 4003(b)(i) provides that an objection to exemption must be filed within 30 days after conclusion of the meeting of creditors, or an extension granted. *See* Fed. R. Bankr. P. 9006(b)(2) providing that the court may enlarge the time for taking action under 4003(b).

- G. Fed. R. Bankr. P. 4003(b)(2) provides that “The 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 trustee shall deliver or mail the objection to the debtor and the debtor’s attorney, and to any person filing the list of exempt property and that person’s attorney.
- H. Fed. R. Bankr. P. 1009(a) provides that “A voluntary petition, list, schedule, or statement may be amended by the debtor as a matter of course at any time before the case is closed.” In other words, there seems to be a wide-open invitation to amend claims to exemption just about at any time in the case.

## II. NEW IN THE EXEMPTION SCHEME SINCE BAPCPA

### A. The 730-Day Rule on Homesteads

Newly numbered § 522(b)(3)(A) provides that “(A) subject to subsections (o) and (p), any property that is exempt under federal law, other than subsection (d) of this section, or the state law that is applicable on the date of the filing of the petition at the place in which the debtor’s domicile has been located for the 730 days immediately preceding the date of the filing of the petition or if the debtor’s domicile has not been located at a single state for such 730-day period, the place in which the debtor’s domicile was located for 180 days immediately preceding the 730-day period or for a longer portion of such 180 day period than in any other place.”

This is a change from former law, which provided that the debtor could exempt property at the place in which the debtor’s domicile had been located for 180 days immediately preceding the filing of the bankruptcy case.

There has been significant development of case law under this new provision of the Bankruptcy Code.

- (1) *In re West*, 352 B.R. 905 (Bankr. M.D. Fla. 2006) (debtor must use federal exemptions because he did not live in Florida for the entire 730 days and could not claim the Indiana state exemptions because he was not domiciled in that state on the date of his bankruptcy filing).
- (2) *In re Crandall*, 346 B.R. 220 (Bankr. M.D. Fla. 2006) (debtor must take the federal exemption if she was not domiciled in Florida for the entire 730 days preceding the filing and lived in New York for a portion of that period, as well as the 180 days immediately preceding the 730-day period; New York law permits exemption only to debtors domiciled in the state).
- (3) *In re Underwood*, 342 B.R. 358 (Bankr. N.D. Fla. 2006) (debtor, who moved from Colorado to Florida less than 730 days prior to the petition filing and was

ineligible to take Colorado exemptions because she no longer lived there either, must take federal exemptions).

- (4) *In re Jewell*, 347 B.R. 120 (Bankr. W.D.N.Y. 2006) (debtor could only use federal exemption even though the state he resided in, New York, and the state he previously lived in, Colorado, were both opt-out states).

An issue existed pre-BAPCPA with respect to which state's exemption law applied when the debtors moved shortly before they filed their bankruptcy petition and wanted to take their former (not the new) state's exemption law. *In re Drenttel*, 403 F.3d 611 (8th Cir. 2005). Here the debtors moved to Arizona from Minnesota, and shortly thereafter, they filed for bankruptcy relief in Arizona, but they used the Minnesota exemption scheme in an attempt to claim their Arizona homestead exempt under 11 U.S.C.A. § 522(b)(2)(A) (2005). The Eighth Circuit held that the language, "the law that is applicable," as used in § 522(b)(2)(A) incorporates the conflicts law of the state in which the debtors were required to file their petition. Minnesota conflicts law would use Minnesota law, and, therefore, the debtors, who were no longer living in Minnesota and no longer had a homestead in Minnesota, could use Minnesota's exemption law as their basis for claiming an exemption under state law. *Drenttel* was the reverse of the situation the new 730-day limitation is designed to cover. Here, debtors were trying to use the exemption laws of the state that they previously lived in, not the state they currently lived in. Under BAPCPA, as read by the courts cited above, the debtor would be limited to the federal exemptions and would not have been able to use Minnesota's \$200,000 homestead exemption.

#### B. Retirement Funds and Accounts

In BAPCPA, Congress added § 522(b)(3)(C) to specify that a debtor electing to use state exemptions (or a debtor in an opt-out state who has to use the state exemptions) may exempt retirement funds to the extent that those funds are in a fund or account that is exempt from taxation under § 401 (a qualified employer-sponsored pension, profit-sharing, or stock bonus plan); § 403 (qualified annuity plans that are established by an employer for one employee under 11 U.S.C.A. § 404(a)(2) or § 501(c)(3)); § 408 (IRAs which meet statutory requirements); § 408(A) (a Roth IRA); § 414 (other retirement plans for controlled groups of employees, including predecessor employers, partnerships, or proprietorships, governments and churches); § 457 (eligible deferred compensation plans established and maintained by eligible employers); and § 501(a) (retirement plans established and maintained by defined tax-exempt organizations). Congress correspondingly clarified that exemption for the debtors taking federal exemptions to parallel the two. 11 U.S.C.A. § 522(d)(12). Rollovers and transfers among such accounts will not expose otherwise exempt accounts to inclusion in the bankruptcy estate. 11 U.S.C.A. § 522(b)(4)(D)(i). Even if the fund has not been previously determined to be nontaxable, it may still qualify under certain circumstances. 11 U.S.C.A. §§ 522(b)(4)(A) and (B). However, only up to \$1,245,475 (excluding rollovers under §§

402(c), 402(e)(6), 403(a)(4), 403(a)(5), or 403(b)(8)) held in an IRA or a SEP IRA is excluded from the estate, unless the court determines that “the interest of justice” requires a greater amount. 11 U.S.C.A. § 522(n). As part of these additions to the exemptions, the automatic stay contains a new exception. New § 362(b)(19) excepts from the scope of the automatic stay withholding of income from a debtor’s wages if the debtor borrowed money from an employee-sponsored plan and agreed to repay the loan, to the extent the amounts withheld and collected are solely for such payments on the loan. And, correspondingly, a new exception from discharge is inserted in 11 U.S.C.A. § 523(a)(18) for sums owed on loans to such plans. Finally, complementary to the new exception from discharge, Chapter 13 plans, under new 11 U.S.C.A. § 1322(f), may not alter the terms of such a loan.

The situation may be different with respect to pledged IRA assets. In a case of first impression decided in a pre-2005 case, a bankruptcy court held that pledged IRA assets are not exempt because § 408(e)(4) of the Tax Code treats as a distribution that portion of the IRA used to secure a loan. *See In re Roberts*, 326 B.R. 424 (Bankr. S.D. Ohio 2004) (relying on *Lewis v. Bank of Am.*, 343 F.3d 540 (5th Cir. 2003 ), which considered the consequence of such a distribution and found that once distributed funds are no longer exempt).

C. *Provisions Designed to Protect the Debtor’s Exemptions Against Nondischargeable Debts*

The Code provides that exempt property may not be levied upon for any pre-petition debt, whether or not the debt is discharged. 11 U.S.C.A. § 522(c). There are, however, four exceptions:

- (1) Exempt property may be seized to pay a debt of certain nondischargeable tax obligations and a nondischargeable “domestic support obligation,” a term newly added by BAPCPA. That term is defined as a debt that 1) accrues before, on, or after the date of the order for relief, and any interest that accrues on that debt under applicable nonbankruptcy law; 2) is owed to or recoverable by a spouse, former spouse, or child of the debtor or such child’s parent, legal guardian, or responsible relative, or owed to or recoverable by a governmental unit; c) is in the nature of alimony, maintenance, or support, including assistance provided by a governmental unit, without regard to whether the debt is expressly so designated; 4) was established on or before the date of the order for relief in a separation agreement, divorce decree, or property settlement, order of a court of record, or determination made in accordance with applicable nonbankruptcy law by a governmental unit; and 5) has not been assigned to a non-governmental entity, except an assignment for purposes of collecting the debt. See 11 U.S.C.A. § 522(c)(1) and definition of “domestic support obligation” in 11 U.S.C.A. § 101(14A) (2006).

## 2016 WINTER LEADERSHIP CONFERENCE

- (a) *In re Davis*, 170 F.3d 475, 479 (5th Cir. 1999) (Old § 522(c)(1) was not an execution statute and did not preempt applicable state law that governs the rights of such domestic support creditors to execute on property. “In other words, § 522(c) sought to leave exempt property exposed to post-bankruptcy liability only to the extent it would have been exposed if the bankruptcy had not occurred.”).
  - (b) *In re Cunningham*, 2006 WL 3438560, \*10 (D. Mass. 2006) (Court concluded that “post-petition conduct—including the voluntary sale of homesteaded property and the consequent conversion into proceeds that may not be exempt under state law—cannot remove previously exempted property from the protections of § 522(c).”).
- (2) Second, valid liens that may not be avoided under the trustee’s powers and certain tax liens on exempt property are not affected by the bankruptcy. See 11 U.S.C.A. § 522(c)(2), as amended by the 1984 Amendments.
  - (3) A third exception was added in 1990 relating to the enforcement of certain nondischargeable debts owed to a federal depository institutions regulatory agency acting as a conservator, receiver, or liquidating agent. See 11 U.S.C.A. § 522(c)(3), added by the Crime Control Act of 1990, Pub. L. No. 101-647.
  - (4) The fourth exception is a debt in connection with fraud in obtaining or providing any scholarship, grant, loan, tuition, discount, award, or other financial assistance for the purposes of financing an education at an institution of higher education. 11 U.S.C.A. § 522(c)(4).

### D. Limitations on the Homestead Exemption

Congress added three new provisions to the Bankruptcy Code: new §§ 522 (o), (p) and (q). Each of these three new provisions caps the homestead exemption in certain cases. All three were effective on the date of enactment of BAPCPA, April 20, 2005. Pub. L. No. 109-8 § 1501(b)(12), 133 Stat. 23, 216 (2005).

#### (1) Section 522(o)

New § 522(o) reduces the debtor’s right to claim an exemption under subsection (b)(3)(B) on an interest in real or personal property the debtor or a dependent uses as a residence, a cooperative that owns property that the debtor or a dependent uses as a residence, a burial plot, or real personal property the debtor or a dependent claims as a homestead to the extent that the value is attributable to otherwise nonexempt property the debtor disposed of in the ten years prior to the filing of the bankruptcy if the disposition was with the intent to hinder, delay, or defraud a creditor. This exception is designed to put the brakes on pre-bankruptcy

planning activity by debtors who were in financial trouble and converted most of their nonexempt assets into cash and invested it in large homes or paid down large mortgages. Courts previously dealt with such activity by treating the action as constituting fraudulent activity sufficient to deny a discharge. This new amendment just gives the trustee one more route to recover the property.

- (a) *In re Maronde*, 332 B.R. 593 (Bankr. D. Minn. 2005) (Debtor engaged in a scheme to defraud his creditors by using his (at the time) good credit to obtain a number of credit cards and use the cash advances, in the form of balance transfers, from those cards to pay off his equity credit line. He then intended to liquidate his truck and trailer to raise cash that he could offer to settle with his new creditors for less than he owed. When the credit card companies refused to take less than the full amount owed, he resorted to Plan B by selling his nonexempt assets (his truck and trailer) to pay down additional debt on his home.).
- (b) *In re Lacounte*, 342 B.R. 809 (Bankr. D. Mont. 2005) (homestead exemption had to be reduced based on debtors' deliberate pre-bankruptcy planning in selling nonexempt assets and using sales proceeds to pay down their home mortgage by \$42,500).
- (c) *In re Agnew*, 2006 WL 3208564, \*6 (Bankr. D. Kan. 2006) (Exemption allowed where assets transferred were partially exempt and fulfilled a legitimate estate planning purpose which the debtor had discussed with his mother long before bankruptcy was a possibility. The transfer fulfilled a purpose other than bankruptcy planning and there was no evidence that the assets had values other than those assigned by the parties to the exchange.).
- (d) *In re Lyons*, 2006 WL 3392619, \*2 (Bankr. D. Mass. 2006) (recording a homestead declaration, which is essentially taking advantage of an exemption available under state law, is not analogous to these types of transfers and is not within the meaning of § 522(o)).
- (e) *In re Anderson*, 386 B.R. 315 (Bankr. D. Kan. 2008).

#### Objection to Homestead Exemption under Section 522(o) Denied

Three months before his bankruptcy filing, debtor paid down the mortgage on his homestead by \$240,000 using non-exempt assets. A lawsuit was pending against him at the time of the payment. The trustee objected under § 522(o). The court found numerous badges of fraud present and determined that the transfer benefited his family to the detriment of his creditors. When debtor was pressed for a reason why he paid down his mortgage instead of his creditors, he responded, "I don't know." Nevertheless, finding the situation to be a "close case," the court denied

the objection. Judge Nugent pointed out that there was “no firm evidence ... that the \$240,000 transfer rendered debtor insolvent.” He also noted that debtor did not conceal the funds he used to pay down his homestead loan or fail to disclose the pre-payment. He also noted that debtor received reasonably equivalent value for the transfer in the form of a dollar-for-dollar reduction of the mortgage debt encumbering his home. The court concluded that “the debtor here did nothing more than take advantage of an exemption to which he is entitled. While his actions were intentional, the Court cannot find that they were done with the intent to hinder, delay, or defraud.” (*Author’s Comment*: This case actually presents classic facts for denial of the homestead exemption under § 522(o). Whenever a mortgage is paid down there is an equivalent reduction of the mortgage debt. That should not even be a consideration. The presence of some of the most obvious badges of fraud should have been sufficient.)

- (f) *In re Stanton*, 457 B.R. 80 (Bankr. D. Nev. 2011).

Debtor's Exemption Planning Unwound under Section 522(o)

Judge Markell begins his opinion with the following: "All siblings fight. Rich siblings fight interminably." He then sets forth that debtor's sister obtained a state court judgment for \$525,000 for, among other things, fraud and breach of fiduciary duty plus another judgment for approximately \$518,000 representing attorney fees and costs incurred in obtaining the first judgment. The Colorado trial court had found that the debtor "lives in a different reality and has little capacity to perceive the actual reality." Debtor had liquidated over \$400,000 in real estate and other investments within months of the entry of her sister's judgment, and then distributed the proceeds to family creditors and immediate family (other than her sister). This was done in a hurried fashion to put assets beyond the reach of creditors. The court determined to reduce the value of her allowed homestead exemption pursuant to § 522(o). Judge Markell traced the history of the code section noting that it utilized the historic language of fraudulent conveyances – first drafted over 400 years ago under the Statute of 13 Elizabeth and that badges of fraud were relied upon to show the intent to hinder, delay, or defraud. He explained that a "badge of fraud" was a fact which made a transaction suspicious, thus calling for an explanation, and then outlined the 11 most commonly relied upon badges of fraud set forth in § 4(a) of the Uniform Fraudulent Transfer Act. He described debtor's actions as “hoary badges of fraud,” engaged in by debtors from time immemorial. The court rejected debtor's uncorroborated testimony that she relied on the advice of others in making the transfers or that she was just taking reasonable actions in light of the economic climate of late-2008. Accordingly, her sister's motion was granted and the exemption limited.

- (g) *In re Roberts*, 527 B.R. 461, (Bankr. N.D.Fla. 2015) (Specie, J.)

Debtors' Homestead Exemption Reduced by the Amount of Non-exempt Assets Liquidated to Build their "Dream Home"

The Debtors had substantial non-exempt assets that they liquidated in order to build their "dream home." At the same time, they were negotiating a short sale of their existing home on the basis of their "financial hardship", and had defaulted on another obligation that they could have easily made the monthly payments on. Essentially, after moving into their "dream home", their largest creditor obtained a judgment against them for over \$1 million. The trustee investigated the source of funds for construction of the "dream home" and objected to the homestead exemption under § 522(o). That provision requires a debtors' homestead exemption to be reduced to the extent that debtors converted non-exempt assets into the claimed homestead within ten years before the bankruptcy filing if shown that they did so by a preponderance of the evidence with the intent to hinder, delay or defraud a creditor. The court undertook a "badges of fraud" analysis, recognizing that debtors seldom admit to hindering, delaying or defrauding a creditor. The court looked to the non-disclosures and misleading information provided to debtors' two largest creditors and the fact that they liquidated all of their non-exempt assets to put into the construction of the "dream home." The court noted that debtors defaulted on renewed loans shortly after renewing them while they were actively transferring all of their assets into the new homestead. The court also found that the debtors' testimony was evasive and, at times, purposely obtuse. Finally, the court noted that a confluence of badges of fraud can constitute conclusive evidence of an actual intent to defraud, which is what the court determined. Accordingly, debtors' homestead exemption was reduced under § 522(o) by \$394,875.28.

- (2) Section 522(p)

New § 522(p) caps the exemption regardless of debtor's so-called bad acts. It provides that "as a result of electing under subsection (b)(3)(A) to exempt property under State or local law, "the debtor cannot exempt any amount in excess of \$155,675 of the interest that was acquired in real or personal property the debtor or a dependent uses as a residence, a cooperative that owns property that the debtor or a dependent uses as a residence, a burial plot, or real personal property the debtor or a dependent claims as a homestead if that interest was acquired within 1,215 days of the filing of the petition. The cap does not apply to state exemptions claimed by a family farmer as a principal residence, and it does not apply where the interest was transferred from a debtor's principal residence acquired prior to the 1,215-day time frame if the debtor's previous and current residences are located in the same state. At the same time, there is a new definition of "debtor's principal residence," 11 U.S.C.A. § 101(13A) provides that

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debtor's principal residence "means a residential structure, including incidental property, without regard to whether that structure is attached to real property." There is also a new definition of "incidental property," which, with respect to the debtor's principal residence, means property commonly conveyed with a principal residence in the area where the property is located; all easements and other intangible rights, such as, oil and gas rights or profits; and all replacement or additions. 11 U.S.C.A. § 101(27B). This new limitation on exemptions was designed to halt a perceived abuse by debtors in financial trouble who move to high homestead exemption states and reestablish residency there. *See In re Hodes*, 402 F.3d 1005 (10th Cir. 2005) (discussing Kansas' expansive homestead exemption.) However, it applies across the board to all debtors and may apply quite inequitably to debtors who have no purpose in moving other than their normal drift from place to place in life.

- (a) *In re McNabb*, 326 B.R. 785 (Bankr. D. Ariz. 2005). Bankruptcy court has held that this new limitation applies only in states which have not opted out of the federal system, of which there are few. *McNabb* was soundly rejected by and criticized as overly technical and not in conformance with congressional intent. *See In re Kane*, 336 B.R. 477 (Bankr. D. Nev. 2006); *In re Landahl*, 338 B.R. 920 (Bankr. M.D. Fla. 2006); *In re Buonopane*, 344 B.R. 675 (Bankr. M.D. Fla. 2006); *In re Summers*, 344 B.R. 108 (Bankr. D. Ariz. 2006).
  - (b) *In Summers*, 344 B.R. 108 (Bankr. D. Ariz. 2006), the bankruptcy court held that § 522(p)(2) allowed the debtor to protect equity that she had transferred from a previous homestead without any cap other than the one provided by state law.
  - (c) *In re Sainlar*, 344 B.R. 669 (Bankr. M.D. Fla. 2006) (The bankruptcy court held that the \$125,000 exemption cap applies only to real property purchased or otherwise acquired by a debtor within 1,215 days of the petition date, not the increase in equity that occurred during that time period.).
  - (d) *See also, In re Kaplan*, 331 B.R. 483 (Bankr. S.D. Fla. 2005); *In re Virissimo*, 332 B.R. 201 (Bankr. D. Nev. 2005); *In re Wayrynen*, 332 B.R. 479 (Bankr. S.D. Fla. 2005) (all of which held that § 522(p)(2) applies in their respective states).
  - (e) *For an end runaround, See In re Schwartz*, 362 B.R. 532 (Bankr. S.D. Fla. 2007 and *In re Buonopane*, 359 B.R. 346 (Bankr. \_\_\_\_\_ D. Fla. 2007) where the full exemption was allowed to a new resident as entireties proper under state law pursuant to § 522(b)(3)(B).
- (3) Section 522(q)

New § 522 (q), the so-called Ken Lay provision, provides that “as a result of electing under § (b)(3)(A) to exempt any amount of an interest in the same four types of property, the debtor may not exempt more than \$25,000 in value if the debtor has been convicted of a felony, which demonstrates that the filing of the case was an abuse of the provisions of the Code, or if the debtor owes a debt arising from a violation of federal or state securities laws or regulations, fraud, deceit or manipulation in a fiduciary capacity or in connection with the purchase or sale of securities registered under federal law; civil remedies under § 1964 of title 18 (RICO); or any criminal act, intentional tort, or willful or reckless misconduct that caused serious physical injury or death to another individual in the preceding 5 years.” However, § 522(q) does not apply to the extent the interest in the property is reasonably necessary for the support of the debtor or a dependent of the debtor.

- (a) *In re Larson*, 340 B.R. 444 (Bankr. D. Mass. 2006), held that the terms “criminal act,” “intentional tort” or “willful or reckless misconduct that causes serious physical injury or death to another individual in the preceding 5 years” includes negligent vehicular homicide.
- (b) *In re Jacobs*, 342 B.R. 114 (Bankr. D.D.C. 2006). One of the few cases discussing new § 727(a)(12) summarized the statute as follows: (1) the debtor must be subject to § 522(q)(1) (i.e., has elected to exempt property under state or local law rather than under the federal exemptions contained in § 522(d)) and (2) the debtor has (a) been convicted of a type of felony that suggests that her bankruptcy filing is abusive; (b) violated certain federal securities laws; or (c) engaged in criminal, intentional, or reckless misconduct leading to the serious physical injury or death of another person in the previous five years. The court held that since the debtor in the case elected to use the federal exemptions provided by § 522(d) rather than the applicable state or local exemptions, she was not subject to § 522(q)(1) and, by extension, § 727(a)(12).

### III. PROCEDURE FOR OBJECTING TO EXEMPTIONS, AMENDMENTS TO EXEMPTIONS, AND APPRECIATION ISSUES

#### A. *Schwab v. Reilly*, 130 S.Ct. 2652 (2010)

Supreme Court reverses Circuit Court’s In-kind Exemption Holding

The debtor in this case had valued her kitchen equipment at \$10,718 and claimed an exemption in that same dollar amount (i.e., claimed an in-kind exemption). The trustee did not object within the 30-day period allowed by Rule 4003(b). When the trustee sought to sell the equipment, the debtor objected to his motion claiming that the asset had been removed from the estate through an exemption, the deadline to object to which had already expired. The Bankruptcy Court, District Court, and Circuit Court all ruled in favor of the debtor. The Supreme Court reversed, agreeing with the trustee (and the United States and National Association of

Bankruptcy Trustees as *amici curiae*) that the Bankruptcy Code defines the property the debtor is authorized to exempt as an interest, the value of which may not exceed a certain dollar amount in a particular type of asset, not as the asset itself. Accordingly, the trustee had no duty to object to an exemption within the limits the Code allowed.

The Supreme Court determined that the Third Circuit erred in holding that the Supreme Court's earlier decision in *Taylor v. Freeland & Kronz*, 503 U.S. 638 (1992), dictated a contrary conclusion. While *Taylor*, likewise concerned a trustee's obligation to object to the debtor's entry of a "value claimed as exempt," there was no colorable basis for claiming the exemption. In *Schwab v. Reilly*, the opposite was true as the amounts listed by the debtor as the value of the claimed exemptions were facially within the limits prescribed by the Code and raised no warning flags that warranted an objection. *Taylor* did not rest on an "unstated premise" that a debtor who exempts the entire reported value of an asset is claiming the "full amount," whatever it turns out to be. Instead, *Taylor* stood for the straightforward proposition that an interested party must object to a claimed exemption if the amount the debtor lists as the "value claimed exempt" is not within statutory limits. The Supreme Court concluded that the debtor's approach "threatens to convert a fresh start into a free pass." The Supreme Court's ruling effectively overturns *In re Green*, 31 F.3d 1098 (11<sup>th</sup> Cir. 1994) where the Eleventh Circuit also interpreted *Taylor* to mean that an in-kind exemption was an indication of a claim that the asset was being fully exempted regardless of its actual value, thereby requiring an objection to the exemption claimed.

**B. Appreciation**

1. Trustees entitled to Sell Homes Based on Post-petition Appreciation

In the two consolidated cases, individual debtors had filed Chapter 7 petitions in 2003 and 2004 respectively and obtained their discharge later in the same year. In each case, there was disclosed equity in the homes that did not exceed the lawful exemption amounts. Debtors had, in fact, listed the dollar amount of equity in each case as exempt. In neither case did the trustee file an objection to the claimed exemption. Because of other assets in the cases, the estates remained open. The trustees believed that while the cases remained open, the homes had appreciated in value significantly. In one case, the trustee sought to employ a broker to sell the home and was met with a motion by the debtor to compel abandonment. The bankruptcy court ruled in favor of the trustee, and the district court affirmed. Debtor then appealed to the Ninth Circuit. In the other case, due to payment defaults, the lender had filed a stay relief motion that the trustee opposed on the basis of the equity. The bankruptcy court ruled against the trustee on the basis of the failure to object to the exemption. The Ninth Circuit BAP reversed and held that the appreciation in the homestead belonged to the estate. That decision was also appealed to the Ninth Circuit. The Ninth Circuit affirmed both the district court and BAP opinions, holding that the increase in value belonged to the bankruptcy estates in each of the cases. *In re Gebhart*, 621 F.3d 1206 (9<sup>th</sup> Cir. 2010). In light of *Schwab v. Reilly*, 130 S.Ct. 2652 (2010), it was clear to the Ninth Circuit that the trustee had no obligation to object to the exemptions claimed in each case even though the value of the claimed exemptions plus the amount of the encumbrances was, in each case, equal to the market value of the residences. The failure to object did not remove the entire asset from the estate. The Ninth Circuit noted that in *Reilly*, the debtor had undervalued the asset where as in these cases they were accurately valued. Nevertheless, any additional value in the

property remained property of the estate regardless of whether the property increased in value after the filing. Moreover, the Circuit Court held that what is frozen as of the date of the filing of a petition is the value of the debtor's exemption, not the fair market value of the property claimed as exempt. Finally, the Circuit Court acknowledged that, in some instances, trustees might be inclined to leave the case open longer than necessary. However, the remedy was to seek an abandonment under § 554(b) or hold the U.S. Trustee to its oversight obligations. Denying creditors assets that had not been exempted was not an available remedy.

[*Author's Comment:* Based on this holding, certainly trustees in the Ninth Circuit will be tempted to keep open cases during rising real estate markets, and debtors will be tempted to move quickly for abandonment under § 554(b).]

## 2. Post-petition Appreciation Belongs to the Estate

Debtor scheduled a one-eighth interest in vacant land that is subject to an oil and gas lease, along with a one-fourth interest in royalties from the lease. No wells had ever been drilled on the land and no royalties were due. Debtor claimed an exemption of \$4,250 in the land interest and \$1.00 in the royalty interest, which were equal to the scheduled values of these assets, utilizing his federal wild card exemption. After no party timely objected to the exemptions, trustee moved to close the case but to except debtor's royalty interest from abandonment in order to preserve the trustee's ability to recover for the benefit of the estate any potential future royalties resulting from a productive well. Debtor agreed to close the case but objected to the trustee's motion to except the royalty interest from abandonment. The bankruptcy court ruled in favor of the trustee, allowing the royalty interest to be excepted from abandonment and holding the trustee was entitled to pursue any future increase in value of the royalty above the amount of the interest listed as exempt. Debtor appealed, and the district court affirmed. Debtor then appealed to the Third Circuit Court of Appeals, which likewise affirmed. *In re Orton*, 687 F.3d 612 (3d Cir. 2012). The Circuit Court agreed with the trustee and lower courts that the wild card exemption preserved only a debtor's interest in an asset rather than the asset itself in that debtor had not unambiguously claimed as exempt a "full" or "100%" fair market value interest in the royalty interest, nor had debtor done anything else to put the trustee on notice of debtor's intent to exempt the entire royalty interest. The Third Circuit further noted that, even if debtor had claimed that the asset was wholly exempt, the Supreme Court in *Schwab v. Reilly*, 130 S.Ct. 2652 (2010) had suggested that "it is far from obvious that the Code would 'entitle' [a debtor] to clear title in [an asset]." The Third Circuit also agreed that any potential appreciation in value above the exempted dollar amount would accrue to the bankruptcy estate, not the debtor. This was also the holding of the Ninth Circuit in *In re Gebhart*, 621 F.3d 1206 (9<sup>th</sup> Cir. 2010).

### C. 100% FMV

#### 1. 100% of FMV Exemption Claim Rejected by 1<sup>st</sup> Circuit BAP

The Chapter 13 debtors claimed exemptions in both their residence and car as "100% of FMV," pursuant to § 522(d). The Chapter 13 trustee objected on the grounds that it exceeded statutory limits and was an improper attempt to capture post-petition appreciation in both the

residence and the car. The debtors countered that the phrase "100% of FMV" was merely a "phrase of art" authorized by the Supreme Court in *Schwab v. Reilly*, 130 S.Ct. 2652 (2010), where the court stated near the end of the opinion that listing the exempt value as "full fair market value (FMV)" or "100% of FMV" would encourage the trustee to promptly object to the exemption if he wished to challenge it and preserve for the estate any value of the asset beyond relevant statutory limits. The bankruptcy court ultimately sustained the objection and ordered the debtors' exemptions limited to specific dollar amounts. It further held that to the extent any appreciation in the exempted assets exceeded the maximum exemption amounts allowed, that appreciation would be property of the estate potentially available for creditors. Debtors also pointed to proposed changes to Official Form C, which would allow a debtor to state the value of the claimed exemption as "the full fair market value of the exempted property." On appeal, the trustee maintained that the claimed exemptions were facially defective and ambiguous and would hinder the administration of the estate. The Bankruptcy Appellate Panel agreed. *In re Massey*, 465 B.R. 720 (1<sup>st</sup> Cir. BAP).

The BAP observed that the Supreme Court questioned the effectiveness of a "100% FMV" type of exemption, noting that (a) such an exemption would not likely pass title to the asset itself, (b) the majority of lower courts to have construed *Schwab* found such exemptions impermissible, and (c) no court had interpreted the Supreme Court's holding as "either unfettered authorization for debtors to exempt assets in-kind or as a mandate for courts to allow such exemptions." It cited with approval the opinion one month earlier from a Massachusetts bankruptcy court, *In re Luckham*, 464 B.R. 67 (Bankr. D. Mass. 2012), that was in line with the majority of courts in finding that the Supreme Court had not outlined a procedure by which an exemption claim could be legitimately converted into an exemption in-kind and that an evidentiary hearing on valuation was unnecessary because the basis of the objection was the manner in which the debtor had claimed it. The BAP further rejected "the argument that proposed changes to Official Form C support in-kind exemptions which exceed the statutory limits," noting that *Schwab* itself precluded such a form-based argument. Finally, the BAP rejected the debtor's policy argument that such a ruling would impair a debtor's "fresh start" referring to the statement in *Schwab* that the approach advocated by the debtors would "convert a fresh start into a free pass."

[*Author's Comment:* On behalf of NABT, the author provided extensive testimony on February 10, 2012, making the same points in opposition to the proposed amendment to Official Form C that this Court makes just three weeks later. The testimony is available on the NABT website.]

## 2. 100% FMV Exemption Claims Potentially Sanctionable

A court in North Carolina consolidated seven Chapter 7 cases where debtors' counsel inserted the following prefatory paragraph in Schedule C-1, "Undersigned debtors are claiming and intend to claim 100% of Debtors' interest in 100% fair market value of each and every item listed, irrespective of the actual value claimed as exempt." The trustee timely objected to the exemptions. Debtors then amended to remove the 100% language and substituted a longer notice that included the language: "If the 'internal net value' of an asset listed below is equal to or less than the amount of the exemption claimed and if that value is less than the maximum amount of

the exemption allowance under applicable law, the debtor exempts the asset from the estate and his entire interest in the asset from the estate." Thus, by inserting this provision, debtors were attempting to exempt their entire interest in every item listed in Schedule C-1 whenever the "net-value" was less than the allowable exemption, irrespective of the item's actual fair market value. Debtors maintained that under *Schwab v. Reilly*, 130 S. Ct. 2652 (2010), they were authorized to claim the full value of an item as exempt, which the notice provision was intended to indicate. The court disagreed and sustained the trustee's objections. *In re Gregory, et al.*, 487 B.R. 444 (Bankr. E.D.N.C. 2013). Judge Leonard analyzed *Schwab* and its progeny and found the extensive body of case law that had developed as almost entirely uniform in rejecting designations such as "100% of the FMV," "100% equity," or comparable language. It found such language also violated the language of the General Statutes of North Carolina and concluded that if counsel persisted in "further use of this language, the court will not hesitate to utilize its *sua sponte* powers under Federal Rule of Bankruptcy Procedure 9011 to require counsel to demonstrate a colorable basis for its inclusion to avoid sanctions."

D. Additional Cases

- (1) *In re Green*, 31 F.3d 1098 (11th Cir. 1994), on the question of the 30-day time limit to object to claims of exemption. In *Green*, the debtor listed a lawsuit at a value of one dollar, but the parties agreed that its value was contingent, not that it had an actual present value of one dollar. The parties also agreed that the debtor exempted the lawsuit for its entire reported value of one dollar, and that the trustee did not object to that exemption claim. In allowing the exemption, the Eleventh Circuit held that "the trustee may not wait until the value of a contingent claim is established before deciding whether to object; instead, he must object within the period allowed by Bankruptcy rule 4003." This case is likely abrogated by *Schwab v. Reilly*.
- (2) *In re Wick*, 276 F.3d 412 (8th Cir. 2002). In *Wick*, the court held that an asset listed as unknown in value may be exempted only to the amount of a statutory exemption amount when the trustee and the debtor were aware that the asset had a value and that the amount claimed under § 522(d)(5) was limited to a dollar amount. In other words, a claim to an asset valued as "unknown" was construed to mean a claim to exemption to no more than the dollar amount allowed by the applicable exemption statute.

C. RESTRICTIVE V. NON-RESTRICTIVE RULES

1. Amended Exemptions Starts New Objection Period Only as to the Exemption Amended or Added

Debtors claimed as exempt three annuities. No objection was filed by the deadline of 30 days from the conclusion of the meeting of creditors as set forth in Rule 4003(b). Thereafter, debtors filed an amendment to Schedule C to add additional property as exempt, but made no changes to the description of the annuities. Within 30 days of that amendment, the creditor objected to the exemption of the annuities. The court denied the objection as untimely. *In re*

*Walker*, 505 B.R. 217 (Bankr. E.D. Tenn. 2014)(Rucker, J.). The court acknowledged that the Rule plainly states that an objection may timely be filed "within 30 days after any amendment to the list or supplemental schedules is filed." It also recognized recent cases applying that plain meaning, *see, e.g., In re Woerner*, 483 B.R. 106 (Bankr. W.D. Tex. 2012); and *In re Larsen*, 2013 WL 4525214, 2013 Bankr. LEXIS 953 (Bankr. D.N.D. 2013). However, the court believed that the better reasoned view was that provided by the "restrictive rule" which provides that the filing of an amendment to the list of exemptions does not reopen the time to object to claims of exemptions not affected by the amendment. The court believed the most important principal was to achieve finality and allow debtors to know that certain assets were no longer property of the estate.

[*Author's Comment*: The court misunderstands that trustees reassess the case and the exemption scheme every time an amendment is filed. Even where exemptions are improperly claimed, a trustee might not object because there is insufficient value to administer on behalf of the bankruptcy estate even if corrected. However, if later amendments add additional assets, then those earlier assets that were over exempted or wrongly exempted become viable in the administrative of the estate in order to make a meaningful distribution to creditors. Perhaps if the objecting party was the trustee who could have explained this principle, the court might have reached a different result.

## 2. Objection to Amended Exemptions Not Limited to the Amended Items

Debtor's Chapter 11 case was converted to Chapter 7. After filing his original schedules, debtor amended them five times. The omission of several items of value that appeared on subsequent amended schedules was, in part, the basis for conversion to Chapter 7. After the final amendments were filed, a creditor objected on the 30<sup>th</sup> day thereafter, asserting that the objection was timely under Rule 4003(b). The debtor, however, asserted that the deadline had long passed on items not previously objected to that had not been amended. The court ruled that the creditor's objection was timely. *In re Woerner*, 483 B.R. 106 (Bankr. W.D. Tex. 2012). Judge Gargotta noted a split of authority between the "restrictive rule," wherein a party in interest has 30 days to object only to changes made by the amendment and not to claims that are unaffected by an amendment, and the "non-restrictive rule" under which a party in interest may object to any claimed exemption within 30 days of an amendment to the schedules. The court observed that the 7<sup>th</sup> and 9<sup>th</sup> Circuit Courts of Appeals and 8<sup>th</sup> Circuit BAP had all followed the "restrictive rule," but with very limited analysis, grounding their respective holdings on the need for prompt action and finality. These arguments were found by Judge Gargotta to be "not convincing." He determined that the plain reading of Rule 4003, which does not limit the scope of the objection, and the interdependence of exemption schemes supported adoption of the "non-restrictive rule". The court concluded that a trustee or other party-in-interest should be allowed to reassess a debtor's use of an exemption scheme upon the filing of any amendment that changes that use, particularly since it would not be prejudicial to the debtor whose prerogative it is to file accurate schedules or amendments thereto. *See also, In re Larsen*, 2013 WL 4525214, 2013 Bankr. LEXIS 953 (Bankr. D.N.D. 2013).

[*Author's Comment*: The "non-restrictive rule" could also be referred to as the "common sense approach." Every time a piece of a case is changed the trustee reassesses the whole.]

3. Grounds for Objecting to Exemptions Not Asserted Before the 30-day Deadline are Waived

Debtors filed Chapter 13 bankruptcy in 2008, shortly after losing their home in foreclosure proceedings. The case was later converted to Chapter 7. At no point during the bankruptcy proceedings did debtors list any legal claims relating to the foreclosure sale. But after receiving their discharge and case closing, debtors filed successive wrongful foreclosure actions in state court without reopening the bankruptcy case to report the claims. Only some four and one-half years later did trustee learn of the claims and have the case reopened. Debtors then amended their schedules to report the claims to be worth \$3 million and claimed wild-card exemptions of \$5,300 each. The trustee objected essentially on bad faith and inequitable conduct. In the meantime, trustee negotiated a settlement, approved by the bankruptcy court, of the wrongful foreclosure claims worth between \$32,000 and \$34,000. The bankruptcy court overruled the trustee's objections in reliance on *Law v. Siegel*, 134 S.Ct. 1188 (2014). Trustee had made an alternative argument at the hearing that debtors were time-barred from claiming exemptions under Rule 1009 which only allowed amendments "before the case is closed." The bankruptcy court held that argument to have been waived because it was not asserted until the hearing. Trustee appealed, but the district court and circuit courts affirmed, *In re Baker*, 514 B.R. 860 (E.D. Mich. 2014), *Ellman v. Baker*, 2015 WL 4033098 (6<sup>th</sup> Cir. July 2, 2015). The courts agreed that even the dicta from *Law v. Siegel* was applicable to bar trustee's initial objection claims. The 6<sup>th</sup> Circuit cited *A.C.L.U. v. McCreary Cty., Ky.* 607 F.3d 439, 447-8 (6<sup>th</sup> Cir. 2010) for the proposition that lower courts are "obligated to follow Supreme Court dicta, particularly where there is not substantial reason for disregarding it, such as age or subsequent statements undermining its rationale." The courts also agreed that the Rule 1009 argument was waived, holding that legal theories could not be changed after the deadline for filing objections had passed and that Trustee had not objected on that basis until the hearing. [*Author's Comment:* Rule 4003(b) requires an objection within 30 days of the conclusion of the meeting of creditors or an amendment to the schedules, whichever is later, but does not require that the grounds for such an objection be stated in that time period. Rule 4003(b)(2) concerning fraudulently claimed exemptions was not discussed because it went into effect after the petition date.]

D. Cases on Burden of Proof and the Standard of Proof

- (1) *Tignor v. Parkinson*, 729 F.2d 977, 979 (4th Cir. 1984) (party objecting to the amendment has the burden of demonstrating that "exceptional circumstances," i.e., prejudice or bad faith warranting denial of the opportunity to amend).
- (2) *In re Arnold*, 252 B.R. 778, 784 n.10 (B.A.P. 9th Cir. 2000) (it is not entirely clear whether bad faith or prejudice must be shown by a preponderance of the evidence or by clear and convincing evidence).
- (3) *But see, In re Yonikus*, 996 F.2d 866, 872 (7th Cir. 1993); *In re Magallanes*, 96 B.R. 253, 256 (B.A.P. 9th Cir. 1988); *In re Brown*, 56 B.R. 954, 958 (Bankr. E.D. Mich. 1986) (holding that the party objecting to exemption on basis of bad faith or prejudice inuring to the trustee or creditors must prove it by a sufficiently clear

showing). The continued vitality of these cases is suspect in view of the *dicta* in *Law v. Siegal*, 134 D.Ct. 1188 (2014).

- (4) *In re Salvucci*, 339 B.R. 279, 281-82 (Bankr. D. Mass. 2006). In *Salvucci*, the court denied the debtors' exemption to proceeds from the sale of their exempt homestead not disclosed on their bankruptcy schedule even though they were later disclosed at a continued § 341 meeting. The court stated that “[g]enerally, if a debtor intentionally conceals or fails to disclose estate property, the debtor will be barred from claiming such property as exempt, even if the property would have been exempt had it been properly scheduled and claimed. . . . Intent to conceal is a factual determination to be made by the bankruptcy court based upon the evidence presented and inferences drawn therefrom at trial. . . . Bad faith is generally determined from an examination of the relevant surrounding circumstances.” Again *Law v. Siegal dicta* may nullify this case except under Rule 4003(b)(3).

E. The Deadline Established in Rule 4003(b) is Not Jurisdictional

There was a clear split among the Circuits over the issue of whether the deadlines in the Federal Rules of Bankruptcy Procedure regarding objections to exemptions and objections to discharge or dischargeability are jurisdictional. This split was resolved by the Supreme Court's decision in *Kontrick*.

In *Kontrick*, the Court noted that courts, including the Supreme Court, have been less than meticulous at times using the term “jurisdictional” to describe emphatic time prescriptions in rules of court. It cited *Taylor v. Freeland & Kronz*, 503 U.S. 638 (1992) as a specific example where the Supreme Court referred to Fed. R. Bankr. P. 4003(b) as jurisdictional. The Court in *Taylor* held that a Chapter 7 trustee could not contest the validity of claimed exemption after 30-day period for objecting had expired and no extension had been obtained, even though debtor had no colorable basis for claiming exemption. But, the Court said, “[C]lassify[ing] time prescriptions, even rigid ones, under the heading ‘subject matter jurisdiction’” can be confounding.

(1) Not Jurisdictional - Waivable

*In re Kontrick*, 295 F.3d 724, 730-33 (7th Cir. 2002), *aff'd*, *Kontrick v. Ryan*, 540 U.S. 443 (2004). The Seventh Circuit held that a debtor could waive his objection to an untimely filed objection to dischargeability if the debtor's objection was not timely brought. In distinguishing *Taylor*, the Seventh Circuit stated that the Supreme Court “did not hold, however, that the debtor had an unlimited time in which to object to the trustee's untimely objection or that Rule 4003(b) was not subject to the usual equitable doctrines that apply to other deadlines and statutes of limitations.” *Kontrick*, 295 F.3d at 733 n.4. The court concluded that the Supreme Court's decision in *Taylor* was not dispositive and held that the timeliness provisions are not jurisdictional. *Id.* The Supreme Court, in affirming the Seventh Circuit, held that no reasonable construction of complaint-processing

rules would allow a litigant situated as debtor to defeat a claim, as filed too late, after the party has litigated and lost the case on the merits.

- (2) Cases Finding the Rules Jurisdictional are now Abrogated
  - (a) *In re Woods*, 260 B.R. 41, 43 (Bankr. N.D. Fla. 2001). “[T]he deadlines provided for in the rules ‘are to be interpreted strictly, and in a manner consistent with the Code’s policies . . . favor[ing the] fresh start for the debtor, and [the] prompt administration of the case.’” (citing *Taylor v. Freeland & Kronz*, 503 U.S. 638, (1992)).
  - (b) *In re Tucker*, 263 B.R. 632, 637 (Bankr. M.D. Fla. 2001). “Absent extraordinary circumstances, the provisions of Rule 4007(c) are jurisdictional and non-waivable.”

D. Use of Equitable Powers to Allow Informal Objection Disallowed

- (1) *In re Canino*, 185 B.R. 584, 594 (B.A.P. 9th Cir. 1995). The court held that to the extent the bankruptcy court used its powers under § 105(a) to carve out an “informal” or *de facto* exception to the plain requirements of § 522(l) and Fed. R. Bankr. P. 4003, it abused its discretion.

**IV. OVERVIEW: EQUITABLE ATTACKS ON EXEMPTIONS**

A. Background

An integral part of the debtor’s fresh start contemplated by the Bankruptcy Code is the ability to shield certain property from creditor claims. 4 *Collier on Bankruptcy*, 522.01 (15 ed. 2003). However, in the course of the administration of an estate, a Chapter 7 trustee may discover that the debtor has been less than candid with the court in its Statement of Financial Affairs and Schedules, which are executed under penalty of perjury. In some instances the debtor will fail to disclose assets and or present false testimony with respect to the same. Upon the discovery of unsecured assets, the debtor might amend the schedules to disclose the asset and thereafter attempt to utilize section 522(l) of the Bankruptcy Code to exempt all or part of its value. The trustee has several options if he or she decides that the debtor has proceeded in bad faith and demonstrated a lack of honesty and good faith concerning her assets and candor towards the bankruptcy court and process.

One obvious alternative is an objection to the claimed exemption(s). Pursuant to Rule 4003(b) of the Federal Rules of Bankruptcy Procedure, a party in interest must file an objection the later of 30 days after the meeting of creditors is concluded or within 30

days after any amendment regarding exemptions. This deadline is critical because pursuant to section 522(l) of the Bankruptcy Code, unless there is an objection the property claimed as exempt will be exempted. The deadlines are applicable even if the debtor has no colorable basis for claiming the exemption. Taylor v. Freeland & Kronz, 503 U.S. 638 (1992). The debtor in Taylor listed the value of a lawsuit as having “unknown” value and claimed an exemption of the same for an “unknown” amount. Subsequent, the lawsuit settled for \$110,000 which far exceeded the relevant exemption limit. The Supreme Court held that since there was no timely objection to the claimed exemption, the debtor was entitled to the entire settlement. The Supreme Court also noted that bad faith is not an issue, absent a timely objection.

B. Equitable Remedies

Alternatively, trustees have been permitted to seek an equitable remedies in these situations. The principal source of the court’s equitable power is section 105(a) of the Bankruptcy Code. Section 105 allows a court to “issue any order, ...that is necessary or appropriate to carry out the provisions of this title.” Section 105(a) also authorizes the court to take “any action....necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process.” One remedy that can be sought under section 105(a) is a disallowance of the debtor’s entire claimed exemption based on a claim of fraudulent concealment of an asset or related transfers. See e.g. In re Yonikus, 996 F. 2d 886 (7<sup>th</sup> Cir. 1993); Sheehan v. Lincoln National Life, 257 B.R. 449 (Bankr. N.D. W. Va. 2001); and In re Park, 246 B.R. 837 (Bankr. E.D. Tex. 2000). But see *dicta* in Law v. Siegal followed by numerous courts that the court has no such authority to disallow an exemption for bad faith conduct.

A second equitable attack trustee previously had utilized was to seek to surcharge or assert an equitable lien against certain assets. The cases that allowed a surcharge or equitable lien turned on very specific fact patterns. This remedy would approve to be overruled by the holding of Law v. Siegal. A sampling of these cases appear below.

V. IMPOSING EQUITABLE LIENS

A. Chauncey v. Dzikowski (In re Chauncy), 454 F.3d 1292 (11<sup>th</sup> Cir. 2006)

Prior to filing bankruptcy, the debtor directed settlement proceeds from a personal injury lawsuit be paid to her mortgage company to reduce the principal balance of the mortgage. The debtor testified that she knew the equity in her homestead would be protected from unsecured creditors, but denied an intent to deceive, defraud or hinder her creditors. The district court affirmed the bankruptcy court’s order denying the debtor’s discharge and imposing an equitable lien on debtor’s homestead in favor of the Chapter 7 trustee. However, under Florida law, an equitable lien may be imposed on a debtor’s homestead only if the funds used to purchase, invest in or improve the homestead were obtained fraudulently. Florida law does not recognize an exception to the homestead exemption where a debtor converts nonexempt assets into a homestead with specific intent to hinder, delay and defraud the debtor’s creditors. The Eleventh Circuit concluded that Debtor’s

conduct did not meet the level of fraud or egregious behavior required by Florida law for imposing an equitable lien. The Court explained, “[h]er decision to delay the filing of a bankruptcy petition until after she received the funds, while blatantly a move designed to deceive her creditors and one made in bad faith, does not rise to the level of fraud, nor does it constitute egregious behavior.” The Court, however, upheld the bankruptcy court’s denial of Debtor’s discharge under sections 727(a)(2)(A) and 727(a)(3).

B. Neilson v. Laing (In re Laing), 329 B.R. 761 (Bankr. M.D. Fla. 2005)

The debtor was the third largest recipient of funds from an investment banking business that was being operated as a fraudulent Ponzi scheme. The investment bank filed bankruptcy in May 2001. In December 2001 the trustee filed an interim report identifying the debtor as a recipient of funds from the Ponzi scheme. In January 2002, in anticipation of a lawsuit against him by the trustee in the investment bank’s case, the debtor obtained a Florida driver’s license and post office box. In April 2002, the debtor purchased a condominium in Florida and declared a homestead exemption. During the period between May 1, 2002 and filing his bankruptcy petition, on February 25, 2004, the debtor spent 164 days in Florida. The trustee in the investment bank’s case objected to the debtor’s homestead exemption and, in the alternative, sought imposition of an equitable lien on the condominium. The bankruptcy court held that the debtor’s motive in purchasing the homestead was irrelevant and the homestead was exempt, unless there was a showing that the transaction fell within the fraud exception under Florida law. The court concluded the debtor was not an active participant in the Ponzi scheme, but a mere recipient of funds greater than he had invested in the company. Additionally, the court concluded that the funds used to purchase the condominium were not funds received on account of the debtor’s fraudulent conduct. Therefore, the court denied the trustee’s motion for the imposition of an equitable lien.

C. In re Hecker, 316 B.R. 375 (Bankr. S. D. Fla. 2004)

The debtor made numerous fraudulent misrepresentations and omissions in connection with the sale of all the stock in a company in which debtor was the sole shareholder. The bankruptcy court determined that the debt created as a result of the sale was nondischargeable as a debt incurred through false pretenses, false representations or actual fraud. The bankruptcy court concluded that the proceeds from the sale were traceable to the funds used by debtor to purchase the homestead. The bankruptcy court granted the creditor an equitable lien on the debtor’s homestead.

D. *In re Financial Federated Title and Trust, Inc.*, 347 F.3d 880 (11<sup>th</sup> Cir. 2003)

The Eleventh Circuit affirmed the order granting the Chapter 11 trustee an equitable lien and constructive trust on the homestead of the debtor’s principal. The Court concluded that the defendant purchased his home with funds obtained fraudulently through a Ponzi

scheme operated through the debtor. The Court held that Florida law provides an exception to the homestead exemption where funds obtained fraudulently were used to purchase, invest in or improve the homestead.

- E. *Havoco of America, Ltd. v. Hill*, 255 F.3d 1321 (11<sup>th</sup> Cir. 2001)

Following the Supreme Court of Florida's answer to its certified question regarding exceptions to the homestead exemption, the Eleventh Circuit affirmed the order that held that the transfer of nonexempt assets into an exempt homestead with the intent to hinder, delay or defraud creditors is not one of the exceptions to the homestead exemption under Florida law, and therefore the debtor was entitled to exempt his homestead even though it was purchased with non-exempt funds with the intent to hinder creditors.

- F. *In re Coates*, 242 B.R. 901 (Bankr. N. D. Tex. 2000)

Prior to filing bankruptcy, the debtors used the proceeds from the sale of a note receivable to satisfy liens on their home and two vehicles. The debtors also made payments to the IRS, their accountant and a lawyer, which were not disclosed in the debtors' statement of financial affairs. The statement of financial affairs also failed to disclose several assets, the transfer of the note, and transfers of property to the debtors' accountant. The trustee objected to the debtors' claims of exemption in their home and two vehicles. Based on the totality of the circumstances, the court concluded that the debtors sold the note and used the proceeds to pay the liens on their vehicles with intent to hinder and defraud creditors and granted the trustee liens on both vehicles. The court, however, held that a lien on the debtors' homestead was not appropriate under Texas law, which provides an exception to the homestead exemption only where the debtors "use the fruits of a fraud" to satisfy the lien on their home.

- G. *Smith v. Moody (In re Moody)*, 862 F.2d 1194 (5<sup>th</sup> Cir. 1989)

The trustee sought to avoid the alleged fraudulent transfer of the debtor's homestead and imposition of an equitable lien on the property. Following the award of a multimillion dollar jury verdict against him for securities fraud the debtor engaged in numerous sham real estate transactions in an effort to hide his assets from his creditors. The Fifth Circuit affirmed the district court's holding that, although the transfer was clearly fraudulent, the trustee was not entitled to an equitable lien on the property because under Texas law the protections of the homestead are absolute, and therefore, the exemption may be allowed in full regardless of a debtor's fraudulent intent.

**VI. SURCHARGING EXEMPTIONS - *LAW v. SIEGAL* 134 S.Ct. 1188 (2014)**

A. No Surcharge of Exemptions per the U.S. Supreme Court

In 2006, the trustee obtained from the bankruptcy court a surcharge of debtor's homestead exemption because of alleged fraudulent conduct. The Bankruptcy Appellate Panel for the Ninth Circuit reversed after determining that the trustee's intent was to punish the debtor for his litigation tactics. In 2008, trustee filed another surcharge motion alleging that the second mortgage on the residence was fictitious and fraudulent and intended to falsely show that the property had no equity beyond the legitimate exemption and mortgage encumbrances so the trustee would not proceed with any sale of that property. Debtor had scheduled the second mortgage for \$156,929 in favor of Lily Lin of China. Debtor forged Lily Lin's name to the deed of trust and had recorded it. The bankruptcy court had ordered the debtor's entire \$75,000 homestead exemption surcharged finding that the loan was fictitious and meant to preserve the debtor's equity in the residence beyond what he was entitled to exempt. *In re Law*, 401 B.R. 447. The debtor refused to cooperate and appealed so many decisions that over a dozen ended up at the appellate level running up the estate's costs to over \$450,000 in legal fees as a direct result of debtor's misrepresentations. This time, the BAP affirmed in an unpublished opinion. *See* 2009 WL 7751415 (9<sup>th</sup> Cir. BAP 2009). The BAP not only affirmed the surcharge but also certain discovery sanctions that had been issued by the bankruptcy court. There was a concurrent opinion by Judge Markell in which he questioned the continuing viability of *Latman v. Burdette*, 366 F.3d 774 (9<sup>th</sup> Cir. 2004), wherein the circuit court first enunciated the legitimacy of surcharging exemptions. His view was in part colored by a contrary view from the 10<sup>th</sup> Circuit in *In re Scrivner*, 535 F.3d 1258 (10<sup>th</sup> Cir. 2008), and also the adoption of Bankruptcy Rule 4003(b)(2) which addressed fraudulently asserted exemptions.

However, after this BAP opinion, the First Circuit Court of Appeals in an opinion authored by Justice Souter also found the appropriateness of surcharging exemptions: "There could not be a clearer example of foiling abusive process than a surcharge order mitigating the effect of fraud in retaining non-exempt assets." *Malley v. Agin*, 693 F.3d 28 (1<sup>st</sup> Cir. 2012). The Ninth Circuit affirmed the BAP opinion (in an unpublished opinion) "because 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." Thus, the Ninth and First Circuits supported the concept of surcharging exemptions and the Tenth Circuit did not, thereby creating a division in the Circuit Courts that the Supreme Court agreed to resolve. *Stephen Law v. Alfred H. Siegel*, Chapter 7 Trustee, 435 Fed. Appx. 697 (9<sup>th</sup> Cir. 2011), *cert. granted* June 17, 2013. A unanimous Supreme Court reversed, *Law v. Siegel*, 134 S.Ct. 1188 (U.S. March 4, 2014) concluding that neither § 105(a) nor any inherent authority of the bankruptcy court, could contravene a specific provision of the Code, such as § 522(k), which expressly prohibited the application of a debtor's exemption to the payment of any administrative expense (excepting certain inapplicable situations). Instead, the bankruptcy courts retain the ability to sanction debtor misconduct by denying the debtor's discharge, imposing sanctions pursuant to Rule 9011, and by imposing other appropriate sanctions under § 105 and the court's inherent authority, but such authority could not contravene an express provision of the Bankruptcy Code. [*Author's Comment*: It is not clear that the outcome would have been different if the surcharge was designed to compensate creditors (as opposed to administrative expenses) for the losses suffered due to the misconduct of the debtor. Section 522(c) also precludes exempt property from being applied to pre-petition debts other than for taxes or domestic support. It is also unclear whether Rule 4003(b)(2) survives, which allows objections

to exemptions as late as one year after the case is closed in situations where an exemption is fraudulently claimed. That Rule was adopted long after the Law case had been filed.]

B. Debtor Allowed Exemption in Fraudulently Concealed Assets

The Debtor in *In re Mateer*, 525 B.R. 559 (Bankr. D.Mass. 2015) (Hoffman, J.), initially filed a chapter 13 petition, claiming exempt his residence. He did not disclose anywhere that the home had been severely damaged by a storm and that he held outstanding insurance coverage claims against his insurer and mortgage lender nor did he at any time disclose these claims to the Chapter 13 trustee. Eventually, debtor was successful in recovering \$126,062.59 on these claims. Nine months after the case was filed, it was converted to Chapter 7. The Chapter 7 trustee reviewed bank statements and noticed sizeable deposits. In response to the trustee's further inquiries, debtor finally disclosed the claims and recoveries. This prompted the trustee to file a motion to compel turnover of the recovered funds. Debtor in turn initiated an adversary proceeding seeking a declaratory judgment that the monies recovered were exempt property. It was undisputed that debtor had properly exempted any equity in his home. However, the analysis with respect to the recoveries on the insurance claims were more complicated. The court recognized that the debtor's failure to disclose could not be excused by the fact that the trustee was insufficiently clairvoyant to ask about an undisclosed matter. The court found that the debtor "intentionally failed to disclose" the existence of his insurance claim and cash payments received. However, the court recognized that the *dicta* in *Law v. Siegal*, 134 S.Ct. 1188 (2014) was a problem for the trustee. It is noted by the court here, that after the Supreme Court concluded its decision on the question presented, it "kept going, changing course and ending up on the subject of whether a bankruptcy court may disallow an exemption claim based on a debtor's fraudulent conduct, a question not before it." In *U.S. v. Ledee*, 772 F.3d 21, 29, n.10 (1<sup>st</sup> Cir. 2014), the First Circuit recognized that the Supreme Court had held that bankruptcy courts do not have "a general, equitable power . . . to deny *exemptions* based on a debtor's bad-faith conduct." (emphasis added). The court here also recognized the holding in *In re Franklin*, 506 B.R. 765, 771 (Bankr. C.D.Ill. 2014) that the Supreme Court had "disavowed the long-standing non-statutory basis for disallowing an exemption where a debtor fraudulently conceals an exempt asset, determining that courts do not have a general equitable power to deny exemptions based on a debtor's bad-faith conduct." Finally, the court concluded that even if Massachusetts state law had recognized a court's equitable power to deny homestead protection to a debtor engaged in fraudulent conduct with respect to the homestead property, binding authority in the First Circuit had held that such power was pre-empted by federal law. *Patriot Portfolio, LLC v. Weinstein (In re Weinstein)*, 164 F.3d 677 (1<sup>st</sup> Cir. 1999). Thus, the court held that "*dicta* or not," the court was bound by it and the trustee's motion was denied and judgment for the debtor granted. [Author's Comment: This would have been an ideal case for the trustee to test the remaining applicability of Rule 4003(b)(2) for fraudulently claiming the exemption.]

C. Exemptions Could Not be Denied on "Bad Faith" Grounds

In *In re Arellano*, 517 B.R. 228 (Bankr.S.D.Cal. 2014) (Taylor, C.J.), Debtor filed with his Chapter 7 petition a fee waiver application that was granted by the court. However, at the meeting of creditors, Trustee determined that Debtor had an unscheduled bank balance of \$4,958.65 and an anticipated tax refund of \$2,000. Debtor proceeded to pay the filing fee in full notwithstanding the fee waiver order and to amend Schedules B and C to now list the omitted

assets and claim them exempt. The Trustee objected to the newly claimed exemption of the omitted assets. Debtor opposed the objection. The court overruled the objection. First, the court recognized precedent from the Ninth Circuit had established that the bankruptcy court could deny leave to amend or disallow a claimed exemption if it was shown either that the Debtor had acted in bad faith or that creditors were prejudiced. The Court noted that the Ninth Circuit had followed the Eleventh Circuit decision of *In re Doan*, 672 F.2d 831 (11<sup>th</sup> Cir. 1982), but it considered the holding abrogated by *Law v. Siegel*, 134 S.Ct. 1188 (2014) because it found the reasoning to be irreconcilable by rebuffing the theory that the general equitable powers of the bankruptcy court could be used to deny a bad faith exemption claim. Instead, the court observed that a properly asserted exemption under § 522 must be allowed unless controlling law provided for disallowance, regardless of whether the exemption was asserted at case initiation or a later point before case closure. Thus, 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.” In *Gray v. Warfield (In re Gray)*, 2014 Bankr. LEXIS 4974 (9<sup>th</sup> Cir. BAP Dec. 9, 2014), debtors’ initial schedules did not list prepaid rent as an asset or claim. Only after the trustee demanded turnover did debtors amend the schedules to list the rent and claim it as exempt. The trustee’s objection was sustained with the court finding debtors acted in bad faith and intentionally concealed the prepaid rent. The BAP reversed, explaining that although the discussion in *Law* on this point was non-binding dicta, it believes *Law* nevertheless “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 Debtor’s bad faith.” See also *In re Elliott*, 523 B.R. 188 (9<sup>th</sup> Cir. BAP Dec. 10, 2014)(state law and 522(g) remain possible avenues of objection).

[*Author’s Comment:* As the courts note, amendments to exemptions, may be freely filed under Rule 1009, but they fail to cite Rule 4003(b)(2) which allows the Trustee to object to an exemption fraudulently claimed by the Debtor. Most likely, the Rule was never raised by the trustees. While standing alone the failure to list either a future tax refund, prepaid rent or the actual bank balance may not rise to the level of fraud, the *Arellano* debtor additionally had sought a filing fee waiver, which would tend to indicate fraud since sufficient funds existed to pay the filing fee in full (not just in installments). Finally, bankruptcy courts like all federal courts have specific equitable powers such as imposing judicial estoppel that is likewise absent from either Court’s discussion.]

#### D. Late Amendment to Exemptions Permitted Over Trustee’s Objection

When Debtor filed her petition, she asserted an exemption claim in an “unknown” amount for a workers’ compensation claim under a category that limited exemptions to around \$10,000. About 16 months later, the claim was settled for \$25,000. Approximately one week later, Debtor amended exemptions to claim under two additional categories thereby fully exempting the settlement. The Trustee objected based on the “late date” of the amendment, and the bankruptcy court sustained the objection. The circuit court reversed on the basis that there was no bad faith or fraudulent concealment alleged or established, nor was there any prejudice to creditors established. Therefore, under existing circuit precedent, there was no basis to deny the exemption as amended. *In re Westry* 591 Fed. Appx. 429 (6<sup>th</sup> Cir. Dec. 30, 2014) The circuit court went on to also analyze the case under the decision of *Law v. Siegel*, 134 S.Ct. 1188 (2014) and found that, if anything, the dicta of that opinion also would have permitted the amendment. [*Author’s Comment:* This is a case where the Trustee never should have even objected to the

amended exemptions. Although not discussed, Rule 1009(a) expressly permits amendments to schedules. Here, it was clear that the debtor had not claimed all of the categories of exemption to which she was entitled for the workers' compensation claim. It should have been anticipated that the debtor would amend eventually to claim all of those exemptions. Additionally, Rule 4003(b)(2) would not have applied to help the trustee since there was no bad faith, fraud, and/or concealment. Thus, although the circuit court discussed *Law v. Siegal*, the trustee's objection could not be sustained even under the law preceding that decision.]

E. Late Change in Exemptions Results in Fee Award against Debtor and his Counsel

In *In re Saldana*, 531 B.R. 141 (Bankr. N.D. Tex. 2015) (Jernigan, J.), debtor originally claimed four, non-contiguous parcels of real property as his Texas homestead that were described as the "French Properties." The trustee, therefore, turned his attention to administering what was referred to as the "Business Properties" consisting of approximately 60 acres. The trustee spent considerable time and effort in evaluating that property, employing an auctioneer and real estate broker, and conducting an auction, none of which the debtor had objected to. More than 15 months after the petition date, and three months after objections to debtor's original homestead exemption were filed by both the trustee and debtor's ex-spouse, more than two months after the trustee had moved and obtained the order allowing him to sell the Business Properties, and midway through a contested hearing for which the parties in court had prepared, the debtor changed his position to instead claim the Business Properties as his homestead and subsequently filed an amendment to that effect. Trustee and the ex-spouse objected.

The court determined that the amended exemption must be allowed under the authority of *Law v. Siegal*, 134 S.Ct. 1188 (2014), but concluded that the bankruptcy court was not denuded under that opinion of its essential "authority to respond to debtor misconduct" and ordered debtor and his counsel to reimburse trustee's and ex-spouse's counsel \$25,245 and \$5,109.50, respectively, in total fees "incurred as a result of the Debtor's bad faith actions in abruptly amending his homestead exemption only after the Trustee, [ex-spouse], and this court had expended significant resources in preparing for a contested hearing that should never have gone forward." The court ordered that this liability be joint and several, "since the court has been unable to determine which of them is more culpable due to the assertion of attorney-client privilege." The court noted that the supreme court in *Law v. Siegel* had specifically stated that Rule 9011 "authorizes the court to impose sanctions for bad-faith litigation conduct, which may include 'an order directing payment . . . of some or all of the reasonable attorneys' fees and other expenses incurred as a direct result of the violation.' . . . the courts may also possess further sanctioning authority under either §105(a) or its inherent powers." 134 S.Ct. at 1198. Although the court did not conclude that the amendment was for an "improper purpose, such as to harass or cause unnecessary delay or needless increase in the cost of litigation," it did find that its inherent power to issue sanctions also existed where a party had "acted in bad faith, vexatiously, wantonly, or for oppressive reasons", in reliance on *Chambers v. Nasco, Inc.*, 501 U.S. 32, at 43-46 (1991). The debtor had "made a calculated decision to assert that the French Properties were his homestead – so long as they could get away with it unchallenged – and only decided to change strategy in the middle of a hearing once it appeared that the Debtor's homestead argument was a losing one." When the court inquired of debtor's attorney what was going on,

the attorney-client privilege was asserted. Thus, the court held debtor and his counsel jointly and severally accountable for the awarded sanctions.

F. Equitable Estoppel applied to deny Debtor’s amended Exemption

In *In re Lua*, 529 B.R. 766 (Bankr. C.D.Cal. 2015) (Saltzman, J.), aff’d 2015 WL 7176005 (C.D.Cal. Nov. 10, 2015), debtor originally claimed her full California homestead exemption of \$75,000. When debtor amended her schedules, she expressly deleted the homestead exemption indicating she had no interest in that property. She also amended Schedule A to state that the property was owned solely by her spouse and two other family members. Instead, she exempted \$9,000 in cash and \$12,500 in accounts receivable under her “wild card” exemption. As a result of these amendments, the trustee did not pursue the personal property items and instead pursued debtor’s interest in the homestead which he believed could still be monetized. Three years after the case was filed, 33 months after the first amended schedules were filed and well after the trustee’s investigation of the homestead, litigation to establish the estate’s interest in and obtaining orders for turnover of the homestead property, retention of counsel, retention of a broker to sell the property, and a settlement with the debtor’s spouse to sell the property and payoff all of her creditors in full, debtor determined to amend her Schedules A and C again to claim a \$100,000 homestead exemption. The court found that debtor’s behavior insured that no funds would be available for unsecured creditors. The trustee objected to this amendment, asserting bad faith, equitable estoppel, and laches. In analyzing *Law v. Siegel*, 134 S.Ct. 1188 (2014), the court concluded that where a debtor claims a state-created exemption, the scope of the exemption - - and any basis for denial of the exemption - - must be found in state law. “It is of course true that when a debtor claims a state-created exemption, the exemption’s scope is determined by state law which may provide that certain types of debtor misconduct warrant denial of the exemption.” *Id.* at 1196-97. The court determined that under well recognized California law, both judicial decisions and as codified, the doctrine of equitable estoppel would apply to debtor’s claim of the amended homestead exemption. The court considered the five factors for application of that doctrine and found all of them compelled disallowance of the exemption: (1) *Representation or Concealment of Material Fact*, satisfied by debtor’s written statement under penalty of perjury that she was not claiming nor entitled to any homestead exemption in the property; (2) *Made with Knowledge of the Facts*, satisfied by debtor’s knowledge that she could claim a homestead exemption and did so in her original schedules and was aware during the following three years of all of the actions that the trustee took to monetize her interest in the homestead; (3) *To a Party Ignorant of the Truth*, satisfied by the fact that the trustee had no knowledge or indication that debtor was going to amend her Schedules three years later, particularly given that there had been no objections or other responses to all of the actions taken by the trustee; (4) *With the Intention that the Ignorant Party Act on It*, satisfied by the debtor’s failure to object or oppose any of the actions being taken by the trustee over a three-year period; and (5) *That Party was Induced to Act on It*, satisfied by the Trustee’s justifiable reliance over a nearly three-year period incurring substantial administrative expenses while otherwise being able to pay nothing to unsecured creditors instead of payment in full. Accordingly, the objection was sustained.

- G. Rule 4003(b)(2) applicable to extend objection to exemption deadline for fraudulently claimed exemption

Debtor filed her chapter 7 petition on October 25, 2013, listing three single family homes, including the subject property on Beckenhan Drive in Granite Bay, California. She initially claimed a \$75,000 homestead exemption on the subject property but later amended it to \$175,000 based on a disability. In her schedules and 341 testimony, she confirmed that her only income was social security and a contribution from a “roommate.” She received a discharge on February 5, 2014, but the case remained open while the trustee administered non-exempt assets. Debtor filed a motion to compel abandonment of the three properties, including the subject property on the basis that there was no non-exempt equity. The court granted the motion over the trustee’s objection as to the third property only. Thereafter, on August 18, 2014, trustee objected to the claim of exemption in the subject property and sought relief from the final order of abandonment, arguing that debtor had fraudulently asserted the claim of exemption in the subject property because she did not reside there on the petition date or at any time during 2013. Trustee relied on tax returns which showed the subject property was a rental property for the entire year, without any personal days. Debtor responded that although she received rental income therefrom, she also resided there during all of 2013. She produced a letter from her CPA saying it was her primary residence solely on the basis of her declaration that she occupied it as her primary residence. She also produced mail addressed to her at the subject property. The bankruptcy court believed that debtor did reside at the subject property but misreported it on her tax returns. The court overruled the objection.

Thereafter, trustee conducted further investigations and determined absolutely that debtor had not resided at the subject property, including affidavits from the tenants who stated that she did not at any point reside there during their tenancy from June 16, 2012 through June 29, 2014. Debtor finally abandoned her argument that she lived at the subject property with “roommates” and admitted that she lived elsewhere. She countered that she did, however, keep some of her personal belongings at the subject property and that her former attorney had advised her that would be sufficient to claim it as her primary residence. Trustee pointed out that the debtor repeatedly mischaracterized the tenants as “roommates/tenants,” when they were in fact clearly tenants with formal leases. Trustee further argued that debtor “from the very first filing, set out to deceive the court, the trustee and her creditors by stating that she lived at the subject property”. The court again overruled the objection finding that trustee was on sufficient inquiry notice to have discovered the fraud and that debtor’s later admissions had no bearing on whether she claimed the exemption fraudulently. Trustee appealed to the bankruptcy appellate panel which vacated the bankruptcy court order and remanded for further proceedings. *In re Stijakovich-Santilli*, 542 B.R. 245 (9<sup>th</sup> Cir. BAP Dec.15, 2015).

The BAP first noted that the usual elements of common law fraud are: (1) misrepresentation of a material fact; (2) knowledge of the falsity of the material fact; (3) intent of defendant to defraud plaintiff; (4) justifiable reliance of plaintiff on that material fact; and (5) damages. The BAP determined that whether a debtor “fraudulently asserted” an exemption claim within the meaning of Rule 4003(b)(2), required that the bankruptcy court apply the usual definition of fraud, except for the damages requirement (which would have no bearing on the question of exemptions). The relevant representation was observed by the BAP to be a debtor’s signed declaration attesting to the accuracy of the information in the statements and schedules

and expressly certifying under penalty of perjury that all statements contained therein were true. These representations were affirmed at the 341 meeting. The trustee also would have to show that debtor knew, at the time she claimed the exemption, that the facts did not support that claim and that she intended to deceive the trustee and creditors who read the schedules. The BAP concluded that the bankruptcy court had erred by imposing a duty to investigate upon the trustee, noting that the “perpetrator of an alleged fraud cannot avoid liability by showing that the victim could have uncovered the fraud had the victim investigated more carefully.” The BAP also stated that “mere negligence in failing to discover an intentional misrepresentation is no defense to fraud.” The “victim need not show that he could not have discovered the fraud; rather, he must only show that he justifiably relied on the perpetrator’s false representations.”

Here, the debtor had asserted a claim of exemption based on false predicates and later continued to mislead the trustee and the court with further false statements. “It would be inappropriate for the debtor to benefit from the fact that the trustee believed her false statements. Therefore, we hold that the bankruptcy court erred when it ruled that the Trustee failed to timely investigate the debtor’s claim of exemption.” Indeed, based on *Hyman v. Plotkin (In re Hyman)*, 967 F.2d 1316 (9<sup>th</sup> Cir. 1992), it was clear that had the trustee initially objected, he could have suffered the bankruptcy judge’s ire because there was no basis to do so from the sworn schedules and testimony. As stated in that case, “any ambiguity in the schedules should be construed against the debtor.” The court also held that “a trustee is entitled to rely on, and need not investigate, the information the debtor chooses to include in the schedules.” Nothing in the schedules had suggested that debtor’s representations therein were untrue. Moreover, she unequivocally stated at the 341 meeting that she resided at the subject property. Thus, the trustee had no basis to object and was not duty bound to have further investigated. Finally, the BAP disagreed with the bankruptcy court’s determination that a debtor’s later statements and admissions could not be used to establish that she fraudulently asserted the claim of exemption in her initial filings. “It is hard to imagine a case in which the debtor’s schedules, standing alone, prove that the debtor fraudulently asserted an exemption. To prove (for example) the debtor’s knowledge of the schedule’s falsity and intent to deceive, the objector will almost certainly have to offer extrinsic evidence. In an appropriate case, this extrinsic evidence may include the debtor’s subsequent statements and conduct.” Thus, the case was remanded to the bankruptcy court to apply the proper standard for the phrase “fraudulently asserted” and to consider whether the evidence showed that debtor had fraudulently asserted the claim of exemption.

#### H. Trustee’s Objection Overruled to Fraudulently Claimed Exemption

Approximately 19 months after her Chapter 7 case was closed, debtor moved successfully to have the case reopened. Debtor filed an amendment to her claimed exemptions, asserting for the first time an exemption of benefits in a life insurance policy. The trustee objected on the basis of bad faith. The trustee specifically asserted that the court should not follow the dicta in *Law v. Siegal*, 134 S.Ct. 1188 (2014) and should allow Rule 4003(b)(2) or judicial estoppel as grounds for disallowing the exemption. The court found that even the dicta of *Law v. Siegal* provided a “clear directive concerning the limits of federal power.” The court further held that “the bankruptcy rules cannot authorize the courts to act in absence of a code provision creating the right.” Finally, the court held that judicial estoppel did not require denial of the amended exemption to prevent a “perversion of the judicial process.” Accordingly, the

court overruled the objection of the trustee. *In re Bogan*, 12-16624 (Bankr. W.D.WI. 2015) (Martin, J.).

I. Rule 4003(b)(2) trumps the *dicta* from *Law v. Siegel*

In *In re Woolner*, 2014 Bankr. LEXIS 5048 (Bankr.E.D.Mich. Dec. 15, 2014) (Shapero, J.), Trustee had timely objected to debtors' claims of exemption, alleging they had "intentionally undervalued those assets in bad faith." Trustee relied on Rule 4003(b)(2) as well as § 105. At the initial hearing, debtors raised the applicability of *Law v. Siegel*, 134 S.Ct. 1188 (2014), arguing that *Siegel* abrogated the authority of bankruptcy courts to deny a debtor's claim of exemptions on the basis asserted by the trustee. At that hearing, the court rejected the debtors' argument concluding that *Siegel* was not dispositive because the issue in that case was whether the bankruptcy court had authority to "surcharge" an already allowed exemption because of the debtors' bad acts and was not a case where the exemption was not directly contested or challenged. Debtors filed a motion for reconsideration based on numerous cases decided thereafter relying on *Siegel* for the proposition that bad faith and even fraud were no longer grounds for disallowing a claim of exemption: *In re Baker*, 514 B.R.860(E.D. Mich. 2014); *In re Mitchell*, 2014 WL 1725819 (Bankr. N.D. Ohio 2014); *In re Guitierrez*, 2014 WL 2712503 (Bankr. E.D.Del. 2014); *In re Arellano*, 517 B.R. 228 (Bankr.S.D.Cal. 2014); *In re Scotchel*, 2014 WL 4327947 (N.D. W.Va. 2014); *In re Gress*, 517 B.R. 543. Bankr.M.D. Pa. 2014), *In re Franklin*, 506 B.R.765 (Bankr.C.D.Ill. 2014); *In re Pipkins* , 2014, WL 2756552 (Bankr.N.D.Cal. 2014); *United States v. Ledee*, 772 F.3d 21, 29 n. 10 (1<sup>st</sup> Cir.2014). The court declined to follow these cases, none of which mentioned, much less discussed, Rule 4003(b)(2) or its relevance or impact. Indeed it was not discussed in *Siegel* either because the rule had gone into effect many years after that case had been filed. The court noted that Rule 4003(b)(2) was not objected to by Congress and was approved and allowed to go into effect by the Supreme Court, being the legal equivalent of something that can be seen as being in the Bankruptcy Code itself. The Court quoted from the Advisory Committee notes accompanying implementation of this rule that provided that "when the exemption claim has been fraudulently made [it] will permit the court to review and, in proper circumstances, deny improperly claimed exemptions, thereby protecting the legitimate interests of creditors and the bankruptcy estate." The deadline of one (1) year after the case is closed was stated to be parallel to the deadline for seeking revocation of a discharge obtained by fraud. The court observes that the "allowance or disallowance of an exemption in the first place is at the very core of the bankruptcy process and is involved in almost all individual cases. It seeks to balance the concepts of giving debtors a fresh start." Accordingly, the motion for reconsideration was denied and the trustee's objections upheld. [*Author's Comment*: The author wrote an article for a scholarly journal on this very subject that was submitted just days prior to the issuance of this excellent opinion thereby missing the opportunity to discuss this case in the article. Rule 4003(b)(2) parallels the same grounds and deadline for revocation of a discharge. It would make no sense to revoke a discharge but allow a Debtor to retain the very property that resulted in the revocation of the discharge due to its fraudulent concealment.]

**VII. ADMINISTERING AN EXEMPTED PI CLAIM (THE “PERSONAL BODILY INJURY” CONUNDRUM)**

A. The Exemption

Section 522(d)(11)(D) provides an exemption for the debtor’s right to receive a “payment, not to exceed \$22,975 on account of personal bodily injury, not including pain and suffering or compensation for actual pecuniary loss, of the debtor or an individual of whom the debtor is a dependent.”

Although approximately three dozen states have opted out of the federal bankruptcy exemptions, many include the exact wording of the federal exemption provision, but limited to different dollar amounts.

On close examination, the terms employed by the statute seem to negate each other by excluding every possible element of a personal injury recovery, seemingly rendering the exemption useless.

B. Legislative History

A review of the legislative history does not provide much assistance. House Report 95-595 states the following:

This provision in subparagraph (11)(D) is designed to cover payments and compensation of actual bodily injury, such as the loss of a limb, and is not intended to include the attendant cost that accompanies such a loss, such as medical payments, pain and suffering, or loss of earnings.

As might be predicted, cases addressing the issue of what is covered by the exemption have been inconsistent in both their approaches taken and ultimate conclusions reached.

C. Case Law Application

1. In *In re Lynn*, 13 B.R. 361 (Bankr. W.D. Wis. 1981), the court rejected the legislative history because it would render the exemption useless. The court noted that personal injury awards are composed of three types of losses: time losses (involving the value of lost time or earning capacity), expenses (such as medical costs), and pain and suffering. The legislative history, however, specifically states that the exemption is not intended to include “medical payments, pain and suffering, or loss of earnings.”
2. In *Ford Motor Credit Co. v. Territo*, 36 B.R. 667, 6670 (Bankr. E.D. N.Y. 1984), the court stated that if read literally, “there exists no meaningful exemption for personal injuries.”

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3. In *In re Sidebotham*, 77 B.R. 504 (Bankr. E.D. Pa. 1987), the court noted that the plain language of the statute itself and its legislative history could not be taken literally if the exemption was to have any meaning. That court determined to follow a balancing test whereby it would weigh the proportion of damages classified as pain and suffering against the severity of the debtor's physical injuries. If the debtor's mental or emotional injuries were significantly greater than any physical injury, the personal injury claim would not qualify for any exemption.
4. In *Lester v. Storey*, 1451 B.R. 157 (S.D. Ohio 1991), the court held that the claimed exemption must be allowed if the debtor had suffered any cognizable physical injury, regardless of proportion.
5. In *In re Marcus*, 172 B.R. 502 (Bankr. D. Conn. 1994), the court determined that Congress had shown its intent to limit the exemption not merely to physical injuries, but to permanent physical injuries. This standard was adopted by the court in *In re Gregoire*, 210 B.R. 432 (Bankr. D. R.I. 1997); *contra*, *In re Lawton*, 324 B.R. 20 (Bankr. D. Conn. 2005); *In re Barner*, 239 B.R. 139 (Bankr. W.D. Ky. 1999); and *In re Romagno*, 159 B.R. 439 (Bankr. S.D. N.Y. 1993). The Court determined that the proceeds of pending personal injury actions for pain and suffering were not exemptible, as remuneration for pain and suffering was specifically excluded from the exemption. The Trustee's exemption was therefore sustained and the funds allowed to be administered by the Trustee.
6. *In re Rochester*, 308 B.R. 596 (Bankr. N.D. Ga. 2004) (Drake, J.): Section 44-13-100(a)(11)(D) does not permit the exemption of amounts received on account of pain and suffering or actual pecuniary loss, which includes amounts received for property damage or medical bills. (citation omitted) Accordingly, damages in excess of \$10,000 and amounts awarded in payment of medical bills would not be exemptible under § 44-13-100(a)(11)(D) and would remain available for payment to creditors. *Accord*, *In re Sanchez*, 2007 WL 445959 (Bankr. W.D. Mich.) at p. 14, FN 16 (Awards for pain and suffering or lost earnings not covered by the federal exemption statute).
7. In *In re Ciotta*, 222 B.R. 626, 628 (Bankr. C.D. Cal. 1998), the court determined that for the exemption to apply, the debtor would have to "demonstrate that a cognizable physical injury has been suffered." The court would not allow the exemption for a sexual harassment cause of action unless the debtor could show a tangible physical injury was suffered.
8. Most courts do seem uniform that if a debtor's claim is for mere pain and suffering without some appreciable or cognizable physical injury, the claim is not exemptible. *See, e.g., In re Scotti*, 245 B.R. 17 (Bankr. D. N.J. 2000), and *In re Claude*, 206 B.R. 374 (Bankr. W.D. Pa. 1997).

D. Stacking

1. Case law supports that debtor is entitled to only one exemption for all of his/her personal injury claims and not the full exemption for each claim. *See, In re Christo*, 192 F.3<sup>d</sup> 36 (1<sup>st</sup> Cir. 1999). (Debtor not allowed to claim the personal injury exemption on each of her three personal injury actions, but only a total exemption of \$15,000 for all of her claims) (majority opinion holds); *contra, In re Comeaux*, 305 B.R. 802 (Bankr. E.D. Tex. 2003)(Debtor allowed to “stack” the exemptions on each claim of personal injury); and *In re Daly*, 344 B.R. 304 (Bankr. M.D. Pa. 2005) (same).
2. Debtor had more than one personal injury claim pre-petition and sought to exempt for each injury claim the maximum federal statutory cap set forth in § 522(d)(11)(D) of \$21,625. The trustee timely objected. The court sustained the court's objection. *In re Phillips*, 485 B.R. 53 (Bankr. E.D. N.Y. December 27, 2012). Judge Trust noted a split of authority on the issue of stacking the personal injury exemptions for multiple incidents and turned to the legislative history. He found that the legislative history created more confusion than clarity about congressional intent and failed to illuminate an answer to the problem. The court returned to a plain meaning analysis and read the exemption statute in light of § 102(7)(the singular includes the plural) and determined that the debtor could not exceed in the aggregate \$21,625 no matter how many accidents and injuries debtor has suffered.

E. Pro-Ration

1. Debtor’s exemption in a PI recovery may be prorated with the bankruptcy estate. *In re Rauser*, 312 B.R. 461 (Bankr. D. Conn. 2004). Here, debtor exempted the statutory maximum under § 522(d)(11)(D), and the Trustee objected. It was undisputed that the claim was worth \$55,000, but there was only \$25,000 of applicable insurance, with poor prospects of collecting from the tortfeasor. The court approved the settlement and authorized the contingency fee portion to be paid to the PI lawyer. That would have left only the amounts sufficient for the exemption with none left over for the bankruptcy estate. The Trustee argued that the remaining funds should be prorated. Because the order approving the settlement did not allocate between the exempt and non-exempt portions, and neither the debtor nor the Trustee was responsible for the inadequacy of the available insurance, the court prorated the remaining funds between the debtor and the estate so that the debtor received \$8,845.45 instead of \$17,425.

F. Allocation and Burden of Proof

1. In *In re Herrington*, 306 B.R. 172 (Bankr. E.D. Tex. 2003), there was no allocation among bodily injury, pain and suffering, actual pecuniary loss, or any other category of damages contemplated by the federal exemption statute contained within the settlement of the PI action by the Trustee. Subsequently, the Trustee did object. He argued that he was precluded from a timely objection

because there was no way to know that the settlement would not allocate the damages among the various possible categories. He also sought to have the exemptions reduced by their prorated share of the attorney fees of the PI lawyer employed by the Trustee as special counsel. The court noted it was the Trustee's burden to prove what portion of the recovery was not exempt. The court also would not allocate any portion of the attorney fees to reduce the Debtor's allowable exemptions.

2. In *In re Buscano*, 2006 WL 3247118 (Bankr. D. Alaska) a settlement had been reached on debtor's personal injury claim, but there was no allocation among the various categories of damages contained within the settlement agreement. The court did not agree that it would be the trustee's burden of proof, but had sufficient evidence in the record to make the determination that the award should be allocated 70% to pain and suffering, which could not be exempted, and 30% to actual bodily injuries to which the claimed exemption could apply.
3. In *In re Kelin*, 341 B.R. 521 (Bankr. W.D. Pa. 2006), a PI exemption was claimed by debtor and there was no objection by the trustee within the 30-day period. Afterwards, trustee had the PI lawyer employed as special counsel. Once a settlement agreement was reached, the trustee filed a motion to approve the settlement and to allocate the settlement proceeds to pay special counsel on a contingency basis as approved by the court, but provided no allocation for the debtor's exemption in the injury claim. Debtor opposed the motion and sought the full exemption as claimed. However, the court noted that the trustee was not challenging the propriety of the exemption but only seeking a determination of whether any portion of the claimed exemption was applicable to the settlement reached. Judge Markovitz found (a) that debtor should have the burden of proof on the allocation issue, and (b) that trustee nevertheless proved that none of the settlement award was within the scope of the allowed exemption because it was for actual pecuniary loss, and (c) it was not necessary for the trustee to object within the 30-day period for this determination to be made.

G. Conclusion

The Trustee must determine how the law on PI exemptions is applied by his or her particular court. Most courts would not allow this exemption provision to be applied to employment discrimination, sexual harassment, and similar claims. Other courts would not apply it even to personal injury actions that are largely based on pain and suffering. Still others would require any physical injury to be permanent to come within this exemption. Therefore, Trustee should consider a more detailed examination of the claim and a possible objection to any exemption thereof.

## VIII. ADMINISTERING AN EXEMPTED IRA/ANNUITY

### A. IRA Received Through Inheritance

An inherited IRA is not exempt unless permitted under applicable state law. *Clark v. Randelor*, 134 S.Ct. 2242 (2014).

#### 1. Supreme Court Holds Inherited IRAs Are Not Exempt "Retirement Funds"

Debtor Heidi Clark was the designated beneficiary of her mother's IRA worth approximately \$300,000. Upon her mother's death, Heidi inherited the IRA and claimed it fully exempt in her Chapter 7 bankruptcy case. The trustee timely objected. The bankruptcy court had agreed with the trustee that the inherited IRA was not exempt, concluding that an inherited IRA does not represent "retirement funds" in the hands of the current owner. *In re Clark*, 450 B.R. 858 (Bankr. W.D. Wis. 2011). Judge Martin had noted that while the funds remained sheltered from taxation until the money was withdrawn, many of the other attributes of the IRA had changed. For example, no new contributions could be made and the balance could not be rolled over or merged with any other account, 26 U.S.C. § 408(d)(3)(C). Additionally, instead of being dedicated to Heidi's retirement years, the inherited IRA must begin distributing its assets within a year of the original owner's death and payout must be completed in as little as five years. 26 U.S.C. § 402(c)(11)(A) incorporating 26 U.S.C. § 401(a)(9)(B). The debtor appealed. Judge Martin's decision was reversed by the District Court, 466 B.R. 135 (W.D. Wis. 2012), which followed recent appellate decisions such as *In re Nessa*, 426 B.R. 312 (8<sup>th</sup> Cir. BAP 2010) and *In re Chilton*, 674 F.3d 486 (5<sup>th</sup> Cir. 2012). Those courts had observed that any "retirement funds" in the decedent's hands had to be treated the same way in the successor's hands because §§ 522(b)(3)(C) and (d)(12) referred to "retirement funds" without providing that they must be the debtor's. It would be enough if they had ever been anyone's retirement funds. The trustee appealed and was joined by NABT in an amicus brief and was opposed by NACBA in an amicus brief before the Seventh Circuit Court of Appeals. The Seventh Circuit reversed and reinstated the holding of the bankruptcy court. *Rameker v. Clark (In re Clark)*, 714 F.3d 559 (7<sup>th</sup> Cir. 2013) *cert. granted*, 134 S. Ct. 678 (Nov. 26, 2013).

In an opinion authored by Chief Judge Easterbrook, the Circuit Court made it seem very simple and obvious that "an inherited IRA does not have the economic attributes of a retirement vehicle, because the money cannot be held in the account until the current owner's retirement." It found that the attributes of an inherited IRA do not in any way resemble "retirement funds." Further, the court concluded: "The district judge thought the question close and believed that close questions should be decided in debtor's favor. We do not think the question close; inherited IRAs represent an opportunity for current consumption, not a fund of retirement savings." The court further concluded that the bankruptcy judge "got this right" and disagreed with the 5<sup>th</sup> Circuit in *Chilton*. The court recognized that it was creating a conflict among the circuits and noted that it had circulated the opinion before release to all judges in active service. "None of the judges requested a hearing *en banc*."

The Supreme Court agreed with the Seventh Circuit and affirmed in a unanimous opinion. *Clark v. Rameker*, 134 S.Ct. 2242 (2014)(Unanimous). The statutes provided an

exemption for "retirement funds to the extent that those funds are in a fund or account that is exempt from taxation" under specified provisions of the Internal Revenue Code. The Supreme Court determined: "The Text and purpose of the Bankruptcy Code make clear that funds held in inherited IRAs are not 'retirement funds' within the meaning of [the statute]." As an objective matter, the court observed that these accounts were not set aside for the day when an individual stopped working and were not objectively set aside for the purpose of retirement. The court focused on the fact that (1) the holder of an inherited IRA is prohibited from making contributions to the account, (2) was required to withdraw money from the account, no matter how many years he or she may be from retirement, and (3) could withdraw the entire balance of the account at any time and for any purpose without penalty, including spending the money on a vacation home or sports car immediately after the bankruptcy case was concluded, thereby turning the debtor's "fresh start" into a "free pass." [*Author's Comment*: Trustees had been making these arguments and losing cases all over the country or winning in the bankruptcy court and being reversed on appeal, which is what happened here when Judge Martin was reversed by the district court. With the contrary appellate opinions from the 5<sup>th</sup> Circuit and the 8<sup>th</sup> Circuit BAP, this looked like the last good chance to turn the tide and bring a measure of common sense to statutory interpretation. Congratulations to the NABT's Amicus Committee and Trustee Bill Rameker.]

2. Inherited IRAs Not Exempt Under Kansas Opt-Out Law

In *In re Mosby*, B.R. (Bankr. D.Kan. June 17, 2015) (Somers, J.), Debtor claimed as exempt the IRA she had inherited from her mother. The trustee timely objected in reliance on *Clark v. Rameker*, 134 S.Ct. 2242 (2014). Debtor argued that the Kansas exemption statute was broader than the federal statute. In reliance on K.S.A. 2014 Supp. 60-2308(b). The court disagreed and sustained the trustee's objection. As an opt-out state, the Kansas state exemption laws were available to the debtor. The court, however, found no material difference between the federal rule and Kansas exemptions. "Whereas the federal exemption applies to 'retirement funds' that are exempted from taxation by specified provisions of the Tax Code, the Kansas exemption applies to payments from an interest in a 'retirement plan' that is qualified under many of the same Tax Code sections. Because of the differences between IRAs and inherited IRAs, it cannot be said that an inherited IRA is a retirement plan." Even though § 408 of the Tax Code was one of the federal statutes enumerated in the Kansas retirement funds exemption statute, the court found that the Kansas statute used that section of the Tax Code, together with other sections, to define qualified retirement plans for purposes of the exemptions. As the court had determined that IRAs constituted retirement plans but inherited IRAs did not, there was no available exemption for the debtor, and the trustee's objection was sustained.

3. Inherited IRA Exempt Under New Jersey State Law

Approximately four months after his chapter 7 petition was filed, Debtor's motion to convert to chapter 13 was granted. In *In re Andolino*, 525 B.R. 588 (Bank. D.N.J. 2015) (Kaplan, J.), Debtor originally disclosed an IRA valued at \$120,000 to which he claimed a full exemption under §522(d)(12). Prior to conversion of the case, Debtor amended his schedules to reflect that the IRA was an inherited IRA from his late mother and not property of the bankruptcy estate. The chapter 13 trustee objected. Here, the bankruptcy court observed that the Supreme Court had held that an inherited IRA did not constitute "retirement funds," as that term

was used in the exemption statute of the Bankruptcy Code. *Clark v. Rameker*, 134 S.Ct. 2242 (2014). However, under New Jersey law statute N.J.S.A. § 25:2-1(b), qualifying trusts remained fully exempt. The court finds that under New Jersey law, the debtor’s interest in the inherited IRA would retain its same designation as a “qualified trust” that it had when owned by the debtor’s mother and, therefore, could not be included as property of the bankruptcy estate. The court recognized that if the debtor failed to comply with the inherited IRA provisions of the tax code, I.R.C. § 408(d)(3)(C) by improperly rolling over the IRA, failing to withdraw the entire balance in the account within five years of the original owner’s death, or failure to take minimum distributions on an annual basis, it could lead to a loss of certain tax benefits as well as a “qualified trust” designation.

4. Inherited IRA Not Exempt Under Louisiana Law

After about four years of marriage, Mark and Kimberly Everett divorced through a consent judgment through which, among other things, Kimberly waived all of her rights to Mark’s retirement accounts. About a year after the divorce, Mark died with Kimberly still listed as the beneficiary of his IRA with a balance of \$245,642.32. Mark’s probate estate obtained a judgment against Kimberly for the amount of the IRA. She then filed a Chapter 13 bankruptcy seeking to exempt the full amount thereof. The bankruptcy court found that the inherited IRA was exempt because Kimberly had “rolled over” the funds from Mark’s IRA to her own IRA. The district court reversed. *In re Everett*, 520 B.R. 498 (E.D.La. 2014) (Brown, J.). The district court noted that contrary to the bankruptcy court’s findings, Kimberly had not rolled the funds over to her personal IRA. Instead, she was required to create a new IRA titled “Kimberly Everett Inherited IRA of Mark Everett,” and required to take distributions therefrom even though she had not reached retirement age. As a result, the court found that the Tax Code no longer afforded the account preferential tax treatment. The court further found that the inherited IRA was a liquid asset rather than a retirement fund in that it was neither exempt under federal or Louisiana state law because it was not a “tax-deferred arrangement.” [Author’s Comment: While this is a properly decided case, it highlights the importance of knowing your own state law exemptions in an opt out state as the Supreme Court’s opinion in *Clark v. Rameker*, 134 S.Ct. 2242 (2014) was only ruling on the federal exemption provisions and specifically noted that it was not binding on a particular state’s exemption laws.]

5. Exempt IRA Not Timely Reinvested Becomes Non-Exempt

The debtors had fully exempted their IRA in *In re Hawk*, 524 B.R. 706 (Bankr. S.D.Tex. 2015) (Bohm, J.). After the deadline for objecting to exemptions had passed, the deadline for objections to discharge had passed and the Chapter 7 trustee had filed a report of no distribution, debtors liquidated their IRA funds. Debtors failed to reinvest the IRA funds within the required 60-day period to retain its exempt status. The Chapter 7 trustee then moved for an order under § 542(a) compelling debtors to turn over the proceeds of the liquidated IRA funds, arguing that the proceeds automatically reverted to the bankruptcy estate based on the failure to reinvest them in another IRA account within the required 60-day period set forth by applicable law. The court agreed with the trustee that the principal was governed by *Viegelehn v. Frost (In re Frost)*, 744 F.3d 384 (5<sup>th</sup> Cir. 2014) and *in re Smith* 514 B.R. 838 (Bankr. S.D.Tex. 2014) which together held that a debtor who sold an exempt homestead and failed to reinvest the sale proceeds in another exempt homestead within six months as required by Texas state law lost the exempt

status and it became non-exempt property of the bankruptcy estate. Here, this principal was applied to hold that the IRA funds lost their exempt status under state law while the bankruptcy case was pending. Once those funds became non-exempt, they were automatically property of the estate subject to the trustee's right of turnover. [*Author's Comment:* In issuing this opinion, the court urged the debtors' bar to counsel carefully their clients about preserving their exemptions by refraining from selling exempt assets until the case was closed; or, if they sell during the pendency of the case, to strictly abide by the reinvestment requirements of applicable state law to preserve the exempt status of the proceeds. This is likewise a "wake up call" to trustees to be diligent in policing exempted assets in states where it matters to properly administer significant assets that have lost their exempt status.]

B. IRA Received Through Divorce/Separation

An IRA awarded in a marriage dissolution may not be exemptible. In *In re Anderson*, 269 B.R. 27 (8<sup>th</sup> Cir. BAP 2001), the court ruled in favor of the Trustee and against the debtor with respect to a property settlement with the debtor's former wife whereby \$25,000 of the former wife's IRA account was awarded to the debtor in the divorce. In that case, the BAP agreed with the Trustee that the assets had to be directly derived from the debtor's employment and not through the divorce settlement. Compare to *In re Nelson*, 274 B.R. 789 (8<sup>th</sup> Cir. BAP 2002), where the same court shortly thereafter ruled that debtor's interest in a former spouse's ERISA-qualified retirement plan obtained pursuant to a QDRO was not property of the estate, relying on *Boggs v. Boggs*, 520 U.S. 833 (1997) (holding that the beneficiaries under an ERISA-qualified retirement plan entitled to protection of the anti-alienation provision included a plan participant's former spouse who was made an alternate payee of the plan through a QDRO).

C. Where the IRA's Underlying Assets are Pledged

At least one court has held that debtors' pledge of funds in their IRAs as security for loans was a distribution of those funds which prevented the debtors from claiming an exemption therein. *In re Roberts*, 326 B.R. 424 (Bankr. S.D. Ohio 2004). *Accord, In re Coppola*, 2005 W.L. 1714365 (C.A. 5-Tex.). Debtors claimed as exempt two IRA accounts in debtor husband's name in the amounts of \$381,272 and \$187,000 and one IRA in the debtor wife's name in the amount of \$96,111. The Trustee objected to the claim of exemption regarding \$500,000 worth of stock pledged by the debtor husband and \$28,000 pledged by the debtor wife as security for certain debts guaranteed by the debtors in favor of a certain bank. The pledges were part of a financing package for the building of an I-MAX theater at a riverfront development. Referring to 26 U.S.C. § 408(e)(4) of the Tax Code, the court noted that if during any taxable year of the individual for whose benefit an IRA is established, that individual uses the account or any portion thereof as security for a loan, the portion so used is treated as distributed to that individual, and a taxable event has occurred. The funds in the account are no longer considered to be IRA funds and, therefore, are no longer exempt. Because the IRA exists only as a result of the Tax Code, the court believed it entirely appropriately to look to the Tax Code to determine whether or not the investment vehicle is an IRA in the first place or whether it has lost its status as an IRA.

D. Where an Annuity is Purchased on the Eve of Bankruptcy

Debtor purchased an annuity for \$33,000 four days before his petition date. Debtor claimed the annuity as exempt under the Colorado provision for “retirement plans.” The Trustee objected to the claim of exemption. The bankruptcy court sustained the objection. *In re Ludwig*, 345 B.R. 310 (Bankr. D. Colo. 2006). Judge Tallman found that the annuity does not qualify as either an IRA or a “retirement plan.” He further held that even if it was such a “retirement plan,” the objection would be sustained in this case because of the numerous badges of fraud present. The court noted that the badges of fraud in fraudulent transfer cases and pre-bankruptcy planning cases are substantially equivalent. He found the following badges of fraud: (I) the annuity was purchased on the eve of bankruptcy, suggesting an intent to keep assets from creditors; (II) the annuity was purchased with the last of debtor’s non-exempt funds, (III) debtor knew that the annuity was not ERISA-qualified; (IV) the transfer to the annuity was for the benefit of insiders, being the debtor and his spouse, and (IV) debtor retained control of the annuity which contained a provision that allowed debtor to “change owners” or “assign” the annuity at any time. Debtor’s defense to these badges of fraud was essentially that he was acting on advice of legal counsel. However, the court found that that was merely one factor to be considered and did not outweigh the other factors here.

E. “Annuities” Not Purchased as Wage Substitutes or for Post-Retirement Compensation

In 1996, debtor inherited \$110,000 and invested a lump-sum of \$50,000 in a Variable Annuity Contract with a maturity date of May 9, 2050, when debtor would attain the age of 85. However, the maturity date and the annuity option could be changed by debtor at any time prior to the initiation of payments, and debtor also retained the right to make withdrawals from the annuity fund prior to the maturity date. If withdrawals were prior to debtor attaining age 59-1/2, they would be subject to a 10% penalty, but only on any accumulated income and not on the initial \$50,000 investment. Debtor valued the annuity at \$80,895 and claimed it exempt under Georgia’s opt-out provision covering retirement or pension plans “to the extent permitted by the bankruptcy laws of the United States.” The Trustee objected to the exemption claim, and the court sustained the objection. *In re Michael*, 339 B.R. 798 (Bankr. N.D. Ga. 2005). Judge Diehl had to examine § 522(d)(10)(E) of the bankruptcy code because of the reference to “bankruptcy laws of the United States.” She also examined by analogy the recent U.S. Supreme Court decision of *Rousey v. Jacoway*, 544 U.S. 320 (2005). She noted that the federal exemption provision protected wage substitutes that served as retirement income for the debtor in the future. Although the term “annuity or similar plan or contract” was used in the statute, debtor’s annuity did not fall within the category of exemptible investments listed. Judge Diehl concluded that “annuity” was a generic term referring to “an obligation to pay a stated sum ... to a stated recipient.” Thus, “annuity” as used in the statute referred to the payment method and not the underlying nature of the asset, which the Trustee’s expert witness had described as an “insurance product.” In the applicable statute, “annuity, or similar plan or contract” referred to benefit plans offered to employees or the self-employed as a means of future compensation after retirement. Likewise, the Supreme Court in *Rousey* had concluded that the common feature of all plans identified in that statute was that they provided income substitutes for wages earned as salary or hourly compensation. Here, the annuity was purchased with a lump-sum contribution of after-tax dollars and had an insurance component to it. The court thus held it was not an “annuity or

similar plan or contract” that could be exempted. In so holding, the court stated: “Exempting an annuity of this nature would open the doors for abuse by debtors and undermine the integrity of the bankruptcy process.” The court continued: “Allowing an annuity contract established by a debtor to be exempt without some requirement that it be similar to other qualified retirement plans would provide debtors with the means of shielding assets from creditors pre-bankruptcy by purchasing annuities under the façade of retirement planning.”

F. Exempt IRA not timely Reinvested becomes Non-exempt

The debtors had fully exempted their IRA in *In re Hawk*, 524 B.R. 706 (Bankr. S.D.Tex. 2015) (Bohm, J.). After the deadline for objecting to exemptions had passed, the deadline for objections to discharge had passed and the Chapter 7 trustee had filed a report of no distribution, debtors liquidated their IRA funds. Debtors failed to reinvest the IRA funds within the required 60-day period to retain its exempt status. The Chapter 7 trustee then moved for an order under § 542(a) compelling debtors to turn over the proceeds of the liquidated IRA funds, arguing that the proceeds automatically reverted to the bankruptcy estate based on the failure to reinvest them in another IRA account within the required 60-day period set forth by applicable law. The court agreed with the trustee that the principal was governed by *Viegelehn v. Frost* (*In re Frost*), 744 F.3d 384 (5<sup>th</sup> Cir. 2014) and *in re Smith* 514 B.R. 838 (Bankr. S.D.Tex. 2014) which together held that a debtor who sold an exempt homestead and failed to reinvest the sale proceeds in another exempt homestead within six months as required by Texas state law lost the exempt status and it became non-exempt property of the bankruptcy estate. Here, this principal was applied to hold that the IRA funds lost their exempt status under state law while the bankruptcy case was pending. Once those funds became non-exempt, they were automatically property of the estate subject to the trustee’s right of turnover.

[*Author’s Comment:* In issuing this opinion, the court urged the debtors’ bar to counsel carefully their clients about preserving their exemptions by refraining from selling exempt assets until the case was closed; or, if they sell during the pendency of the case, to strictly abide by the reinvestment requirements of applicable state law to preserve the exempt status of the proceeds. This is likewise a “wake up call” to trustees to be diligent in policing exempted assets in states where it matters to properly administer significant assets that have lost their exempt status.]

G. Trustee entitled to Turnover of Sale Proceeds from Debtors’ Homestead that was not Timely Reinvested

When debtors filed their Chapter 7 petition in 2010, they listed their residence in Prescott Valley, Arizona and claimed it as exempt in the amount of \$70,279 pursuant to A.R.S. § 33-1101(A). The schedules were never amended nor was any objection to the exemptions ever filed. Debtors received their discharge later that year. Two years after the petition date, debtors filed a motion to sell the property, free and clear of the estate for \$280,000, indicating that any equity realized would be protected by the homestead exemption. Trustee filed no objection to that motion, did not attend the hearing thereon, and did not appeal the order granting the motion. Approximately eight months later, debtors filed a motion to determine that the proceeds from the sale were not property of the estate, indicating that the trustee had advised debtors that the proceeds would become property of the estate if they did not reinvest the funds in a new

residence before the expiration of the 18-month period required under Arizona law. The trustee objected to the motion. After the 18-month period had run with no reinvestment of the proceeds, the trustee promptly filed a turnover motion. The bankruptcy court issued a preliminary order directing the trustee to file an affidavit explaining why he did not close the debtors' bankruptcy case prior to the expiration of the 18-month reinvestment period which was nearly four years after the petition date. The trustee's declaration explained that he had not closed the estate for reasons unrelated to the homestead sale, which the bankruptcy court found to be a reasonable explanation and granted the turnover motion, holding that the proceeds from the post-petition sale were subject to the reinvestment period under A.R.S. § 33-1101(C). Debtors appealed to the district court, which affirmed. *In re Smith*, 526 B.R. 343 (D. Ariz. 2015)(Campbell, J.).

Debtors argued that the trustee was judicially estopped from seeking turnover. The bankruptcy court rejected that argument finding the effect of the sale order to be unclear, with no citation of any authority to support the relief and noting that the "free and clear" language used by the debtors in their sale motion appeared in § 363(f) which applied to trustees but not debtors. Additionally, the order on the sale motion did not even decide whether the sale was subject to the reinvestment requirements of § 33-1101(C). The district court agreed with the bankruptcy court that the sale order was unclear and that the trustee could therefore not be said to have taken a position with respect to the order that was "clearly inconsistent" with its position now, as required by Supreme Court precedent. *New Hampshire v. Maine* 532 U.S. 742, 750 (2001) The other elements of judicial estoppel were also lacking, as the trustee had never persuaded the bankruptcy court to take any position at all at the time of the sale motion, nor were the debtors misled as the trustee had made his position to them quite clear. Next, although not raised below, the district court considered on appeal debtors' new argument that the reinvestment requirement was trumped by §§ 522(c) and (k). The district court rejected that argument based on a prior circuit precedent and *In re Jacobson*, 676 F.3d 1193 (9<sup>th</sup> Cir. 2012), where the circuit court held that bankruptcy exemptions were fixed at the time of the petition, and the entire state law that was applicable on the petition's filing date, including the reinvestment requirement was determinative of whether an exemption applied. The circuit court had concluded that proceeds from the sale of a homestead lost their exempt status and were subject to turnover. Finally, debtor argued laches, the docket showing no affirmative action by the trustee for nearly three years. But the bankruptcy court had accepted as reasonable the explanation in the trustee's declaration, and his turnover motion was filed only six weeks after the expiration of the 18-month reinvestment period. Thus, the district court concluded that the bankruptcy court had not abused its discretion. The district court also observed in affirming the bankruptcy court, that at any time the debtors could have filed their own motion to compel abandonment of the estate's interest in the sale proceeds, but never did so.

A view seemingly contrary to the reinvestment requirement (but actually distinguishable) was recently stated in *In re Golden*, 528 B.R. 803 (Bankr. D.Col. 2015)(Tallman, J.), a Colorado case where the chapter 13 debtor had obtained plan confirmation with the provision that all property of the chapter 13 estate revested in the debtor upon confirmation. Thereafter, debtor and his estranged spouse sold the real property, generating \$33,169.42 of net sale proceeds which were then transferred to the estranged spouse with whom the debtor was separated. Debtor did not seek court authorization for the sale or the transfer of funds. When the case converted to Chapter 7, the trustee sought to avoid the transfer to the estranged spouse under §

549(a). However, the court held the action to be moot because the homestead had left the bankruptcy estate when it reverted in the debtor upon plan confirmation. Judge Tallman also noted that under § 348(f)(1)(A) property of the estate in the converted case included property on the petition date “that remains in the possession or is under the control of the debtor on the date of conversion.” The property and the proceeds were no longer in the possession or control of the debtor on the date of conversion. Thus, the court held the property had already lawfully left the estate and could not be recovered or administered by the trustee. The court distinguished other cases because they were either filed under Chapter 7, converted to Chapter 7 pre-confirmation, or were under a plan that provided that the property remain property of the estate, and thus came into the Chapter 7 estate and could be administered by the trustee.

H. Homestead Proceeds from Foreclosure Sale During Bankruptcy Held Property of the Estate Where Not Reinvested

Creditor lifted the stay in debtor's bankruptcy and sold debtor's homestead in a foreclosure sale with a portion of the proceeds paid to the debtor as required by the California homestead exemption. The California homestead exemption provides that the debtor's portion of the proceeds loses its exempt status if not reinvested within six months. The debtor did not reinvest the proceeds in that window. Trustee filed complaint against debtor and her husband seeking turnover of the proceeds from the sale, a rental property held in the husband's name, and income earned from that property. The bankruptcy court rejected all of the trustee's claims and the Ninth Circuit Bankruptcy Appellate Panel affirmed. The trustee appealed and the Ninth Circuit reversed in part, holding that the proceeds from the homestead sale belonged to the estate, but the rental property held in her husband's name and the income from it did not. *Wolfe v. Jacobson (In re Jacobson)*, 2012 U.S. App. LEXIS 8103 (9th Cir. 2012).

The Ninth Circuit reasoned that under the “snapshot” rule, bankruptcy exemptions are fixed at filing and whether an exemption applies must be determined by the *entire* applicable state law. In this case, the entire applicable law included a reinvestment requirement. Although the debtor had a right to the exempt proceeds, that right was contingent on reinvesting in a new homestead within six months. Because the debtor did not do so, she forfeited the exemption. As to the rental property, the Ninth Circuit agreed that the trustee's claim failed because the title documents showed that debtor's husband was the sole owner and in California, record title is presumptively correct. In addition, there was no presumption of community property where the husband acquired the property in his name alone and it was traceable to his separate inheritance. Finally, the court rejected the argument that because the bankruptcy court had found that the debtor ran her husband's affairs in a previous case, the debtor was estopped from arguing she had no interest in the property. It was not inconsistent for the husband to own separate property and let the debtor run his affairs.

I. No intent to Reinvest Requirement for Illinois Homestead Exemption

Debtors sold their Illinois homestead and, after filing for chapter 7 bankruptcy, claimed an exemption on \$9,000 remaining in an account from the proceeds of the sale. The Trustee objected, because the debtor had stated that she had no intent to reinvest the proceeds in a new home. The Bankruptcy Court allowed the exemption. *In re Lantz*, 446 B.R. 850 (Bankr. N.D.

Ill. 2011), holding that 735 Ill. Comp. Stat. Ann. 5/12-901 did not contain an intent requirement such that the debtor must intend to invest the sale proceeds in a new homestead. The decision counters an earlier decision from the Central District of Illinois, *In re Ziegler*, 239 B.R. 375 (Bankr. C.D. Ill. 1999), which held that an intent requirement is implied in the homestead statute. In predicting that the Illinois Supreme Court would not acknowledge any intent requirement in the statute, Judge Barbosa looked to the unambiguous language of the statute, which contained no express intent requirement. The decision also noted the liberal construction afforded exemption statutes under Illinois law in favor of debtors.

## IX. STATE SPECIFIC EXEMPTION STATUTES

### A. 11<sup>th</sup> Circuit and 6<sup>th</sup> Circuit

#### Bankruptcy Specific Exemption Statutes held Constitutional

A Georgia bankruptcy-specific exemption statute enables Georgia debtors who file for bankruptcy to exempt their aggregate interest, not to exceed \$2,000, in the cash value of unmaturing life insurance contracts; whereas, Georgia debtors who were not in bankruptcy, could claim the full cash value of whole life insurance contracts as exempt. The bankruptcy and district courts had ruled that this disparity did not violate the uniformity provisions of the bankruptcy clause of the United States Constitution. The statute applied uniformly to all debtors in bankruptcy, which was all that the uniformity provision required. Moreover, the statute did not violate the Equal Protection Clause of the Georgia constitution because bankruptcy debtors and non-bankruptcy debtors were not in similar circumstances, and the Georgia legislature did not have to provide the same treatment for each class of debtors. The lower courts also denied an exemption in an annuity that was created when debtor was 64 in 2006 with a single payment of \$150,000 with payments deferred until age 90 in order to increase the death benefit for his wife. Debtor retained full control and discretion over the terms of the annuity, including the ability to cancel it or withdraw all funds therein in a lump sum if he so chose. This was determined to be an investment vehicle and not a wage substitute. On further appeal, the Eleventh Circuit affirmed. *McFarland v. Wallace*, 2015 WL 3825078 (11<sup>th</sup> Cir. June 22, 2015). Accord *In re Schafer*, 689 F.3d 601 (6<sup>th</sup> Cir. 2012); *Sheehan v. Peveich* 574 F.3d 248 (4<sup>th</sup> Cir. 2009); *In re Kulp*, 949 F.2d 1106-1109 n.3 (10<sup>th</sup> Cir. 1991); *In re Applebaum* 422 B.R. 684 (9<sup>th</sup> Cir. BAP 2009)

### B. 4<sup>th</sup> Circuit

#### Bankruptcy-specific exemption statute constitutional

West Virginia has “opted out” of the Federal Bankruptcy Exemption Scheme, thereby restricting its debtors to exemptions available only under state or local law and federal, non-bankruptcy law. The applicable state exemption provisions apply only in bankruptcy proceedings, even though West Virginia has other exemptions, not at issue in the case, that apply to judgment debtors generally. The trustee objected to the debtor’s claim of exemption, arguing that state exemption laws that apply only in bankruptcy cases are inconsistent with the bankruptcy code’s objectives regarding the distribution of estate assets and are, therefore, rendered invalid by the Supremacy Clause. The bankruptcy court disagreed, allowing the

exemptions. A direct appeal was certified to the Fourth Circuit. *Sheehan v. Peveich*, 574 F3d 248 (4<sup>th</sup> Cir. 2009). The Circuit Court found: “This statutory provision [§ 522(b)(1)] is an express delegation to the states of the power to create state exemptions in lieu of the Federal Bankruptcy Exemption Scheme.” The Circuit Court continued: “Congress has not seen fit to restrict the authority delegated to the states by requiring that state exemptions apply equally to bankruptcy and non-bankruptcy cases, and we are without authority to impose such a requirement.” Consequently, the bankruptcy court decision was affirmed.

**X. ADMINISTERING EXEMPTED PROPERTY THAT IS BROUGHT INTO THE ESTATE BY THE TRUSTEE’S AVOIDANCE POWERS**

A. § 522(g)

Section 522 provides that:

(g) Notwithstanding §§ 550 and 551 of this title, the debtor may exempt under subsection (b) of this section property that the trustee recovers under §§ 510(c)(2), 542, 543, 550, 551, or 553 of this title, to the extent that the debtor could have exempted such property under § (b) of this section if such property had not been transferred, if –

- (1)(A) such transfer was not a voluntary transfer of such property by the debtor; and
- (B) the debtor did not conceal such property; or
- (2) the debtor could have avoided such transfer under subsection (f)(2) of this section.

[Emphasis added]. Note that the term “recovers” is not defined in the bankruptcy code.

B. Rule 4003(b) – Objecting to a Claim of Exemptions

This rule provides in pertinent part:

A party in interest may file an objection to the list of property claimed as exempt only within 30 days after the meeting of creditors held under § 341(a) is concluded or within 30 days after any amendment to the list or supplemental schedules is filed, whichever is later.

C. *Taylor v. Freeland & Kronz*, 503 U.S. 638 (1992)

In *Taylor*, a Chapter 7 debtor had claimed an exemption in potential proceeds from a pending employment discrimination suit. The *Taylor* court held that the Trustee could not contest the validity of the claimed exemption, even though the debtor had no colorable basis for claiming it, because the 30-day period for objecting under Rule 4003(b) had expired and the Trustee had not obtained an extension of time. *Id.* at 643-44.

However, *Taylor* did not involve any issue of whether § 522(g)(1) applies despite the lack of a timely objection under Rule 4003(b). Most courts that have considered the issue after *Taylor* do not apply Rule 4003(b) where the Trustee's objection is based on § 522(g).

D. Majority View - Trustee Not Subject to 30-Day Objection Deadline Nor Is Formal Action Required

Virtually all courts recognize that the 30-day objection period is in conflict with the Trustee's two years' limitations period under § 546(a)(1)(A) and, therefore, do not find the failure to object within the 30-day limitations period of Rule 4003(b) to be a bar to a later objection to an exemption claim.

E. *Glass v. Hitt (In re Glass)*, 60 F.3d 565 (9<sup>th</sup> Cir. 1995) - Trustee Can Object Without Formal Avoidance Action Outside the 30-Day Period

At the bankruptcy court level, the court had overruled the Trustee's objection to an exemption claimed that was filed after the 30-day deadline. The Trustee relied on § 522(g). The bankruptcy court found that Trustee did not "recover" the property claimed as exempt because no formal action was taken by the Trustee. The BAP reversed. 164 B.R. 759 (9<sup>th</sup> Cir. BAP 1994). The Ninth Circuit Court of Appeals affirmed the BAP agreeing with and adopting its reasoning. The BAP held:

It is not necessary for the Trustee to commence a formal adversary proceeding or obtain a final judgment to prevail on an objection to a debtor's claim of exemption pursuant § 522(g)(1) A Trustee, however, must present sufficient facts upon which a bankruptcy court could reasonably conclude that a debtor transferred property in such a manner as to invoke the Trustee's avoidance powers. 164 B.R. at 764-765.

The BAP further observed that in the bankruptcy context a Trustee may "recover" fraudulently transferred property in a number of ways, including by merely using the threat of avoidance powers to induce a debtor or transferee to return the property to the estate. *Id.* at 763.

The Ninth Circuit Court further agreed with the BAP's observation that "providing an exemption for this Debtor who fraudulently transferred property and then was not honest in reporting his assets or pre-petition transfers, would not promote either the specific policy of § 522(g) or the general policies of the Code." *Id.* at 765.

The Ninth Circuit Court of Appeals found the BAP's analysis compelling. It further noted that under the holding of *United States v. Ron Pair Enterprises, Inc.*, 489 U.S. 235, 242 (1989), the "plain meaning of legislation should be conclusive, except in the rare cases in which the literal application of a statute will produce a result demonstrably at odds with the intentions of its drafters." The Ninth Circuit felt that a debtor should not be permitted to injure his creditors and then cause additional injury to them by claiming an exemption that will further diminish the funds available for those very creditors.

- D. *Levine v. Weissing (In re Levine)*, 134 F.3d 1046 (11<sup>th</sup> Cir. 1998) -Trustee proceeding under 522(g) is not limited to the 30-day deadline

In *Levine*, debtors had voluntarily and fraudulently transferred non-exempt assets to various insurance companies to purchase annuities that were exempt from creditors' claims under state law. The Trustee had not timely objected under Rule 4003(b). The *Levine* court specifically held that Rule 4003(b) did not bar a Trustee from bringing an adversary proceeding under the bankruptcy code to contest the transfer of funds. The *Levine* court found that the Trustee's actions were subject to the two-year statute of limitations governing adversary proceedings under the Trustee's avoidance powers under § 546(a)(1)(A). The court concluded that to hold otherwise, the two-year limitations period would effectively become a 30-day limitations period, thereby rendering the provision meaningless.

- E. *In re Duncan*, 329 F.3d 1195 (10<sup>th</sup> Cir. 2003) - Subsection 522(g)(1) Applies Despite the Lack of a Timely Objection Under Rule 4003(b), and No Formal Action by Trustee is Required

Trustee avoided certain fraudulent transfers of property and then proceeded to sell the property with court approval. The debtor objected because the notice did not include reference to the debtor's \$10,000 homestead exemption. Debtor also objected because the Trustee had not timely objected to this exemption under Rule 4003(b). The Trustee argued the exemption was invalid under § 522(g). The bankruptcy court ruled that debtor was not prevented by § 522(g)(1) from claiming his homestead exemption. That ruling was affirmed by the BAP at 271 B.R. 196 (10<sup>th</sup> Cir. BAP 2002). The Circuit Court reversed. The BAP had believed that the phrase "property that the Trustee recovers" was not met in this instance and that alternatively the objection was not timely filed. The Tenth Circuit Court disagreed with both of those conclusions. Instead, it agreed with the Ninth Circuit and the Eleventh Circuit in the *Glass* and *Levine* decisions. Specifically, the *Duncan* court held that the Trustee was not subject to the 30-day limitations period under 4003(b) when he had recovered property under 522(g). "Were we to hold otherwise, the two-year limitations period of § 546(a)(1)(A) would effectively become a 30-day limitations period, thereby rendering the provision meaningless." The *Duncan* court also agreed with the Trustee's position, represented by the *Glass* decision, that § 522(g)(1) embraces "all recoveries under the applicable code sections and did not require specific formal action."

- F. *In re Kuhnel*, 346 B.R. 528 (10<sup>th</sup> Cir. BAP 2006) – Lien Release Not Involving Fraud Requires 30-Day Objection by Trustee, Reversed 495 F.3d 1177 (10<sup>th</sup> Cir. 2007)

In *Kuhnel*, the Trustee did not timely object to debtors' exemption claimed in a Toyota, the lien against which was unperfected by the filing date. Later, the lien on the Toyota was released in response to a demand made by Trustee's counsel. Thereafter, Trustee did object to the claimed exemption. The bankruptcy court sustained the objection in reliance on *Duncan*. The BAP majority reversed, distinguishing *Duncan* as limited to cases where the trustee recovers fraudulently conveyed property through an avoidance

action. In dissent, Judge Michael found no such limitation in *Duncan*. He noted that, as a matter of law, the granting of a lien in a vehicle constituted a voluntary transfer under § 522(g)(1) that was avoidable by the trustee under § 544. He concluded that formal legal action was not required nor was the trustee, when proceeding under § 522(g)(1), required to object within the 30-day period. The circuit court agreed with the dissent and reversed.

- G.** *In re Randolph*, 546 B.R. 474 (Bankr. N.D.Ga. 2016) Debtor cannot exempt what he no longer owns, nor will a “voluntary” re-conveyance allow an exemption.

Property interest transferred eleven days pre-petition. Debtor claimed an exemption in the property transferred. Trustee objected. Sustained. Debtor cannot exempt what he does not own. If Trustee avoids the transfer or the property is re-conveyed, then under §522(g)(1) debtor would be prevented from claiming an exemption. Trustee’s objection to exemptions was sufficient action to satisfy the recovery element.

- H.** *In re Nersinger*, 2006 WL 3231382 (Bankr. W.D. N.Y.) – Debtor’s Exemption Preempts Estate’s Interest in Avoided Mortgage Liens Reconsidered and Trustee’s Objection Sustained, 2007 WL 438212 (Bankr. W.D.N.Y. 2007)

Debtor claimed in her Chapter 7 petition a \$30,961.09 homestead exemption under New York law. She indicated the home had a value of \$127,700 and was subject to secured claims totaling \$112,058.65. No one objected to the exemption claim before the 30-day deadline and, thereafter, the Trustee sold the home and avoided the two mortgage liens against it. Trustee then objected to the homestead exemption claim pursuant to § 522(g). Trustee asserted that the exemption was limited to the \$5,000 of equity above the avoided mortgage liens, whereas debtor insisted on the full amount. The court initially ruled in favor of the debtor, on a Motion for Reconsideration realized Judge Ninfo realized he had holding that under *Taylor v. Freeland & Kronz*, 503 U.S. 638 (1992), property claimed as exempt is exempt when there are no objections timely filed even if there is no basis in law or fact to claim it. Since no objection was timely filed, the court overruled the objection and allowed the debtor’s claimed amount to be paid from the sale proceeds. ...misread *Taylor*. Here, there was no basis to object to the debtor’s validly claimed homestead exemption. Such an exemption would only attach to any available equity in the home. Under § 551, the avoided mortgage liens are preserved for the benefit of the bankruptcy estate; therefore, even without an objection, the homestead exemption could have attached only to the equity above the mortgage liens as the trustee asserted. Accordingly, he reversed himself and sustained the trustee’s objection.

- I.** *In re Hicks*, 342 B.R. 596 (Bankr. W.D. Mo. 2006) – No formal Action Required or Timely Objection Needed

In *Hicks*, the Trustee objected to debtor’s claimed exemption in a Cadillac Escalade on the ground that any equity resulted from his § 544 avoidance powers and consequently, § 522(g) precluded any exemption by the debtor therein. Debtor asserted that Trustee had not taken any affirmative action to avoid the lien and therefore could not utilize § 522(g). Trustee responded that the lender had conceded right away that its lien was not perfected.

The court sustained the objection, noting that there will be cases where a lien is patently unperfected and the creditor will yield to the Trustee without much effort. Judge Finerman noted that such property comes into the estate pursuant to the Trustee's powers nevertheless, and the debtor may not claim such property as exempt. Otherwise, he concluded the Trustee would always be required to file an adversary action resulting in unnecessary and wasteful litigation.

**J.** *In re Witt*, 273 B.R. 563 (Bankr. W.D. Wis. 2000) – No Formal Action Required or Timely Objection Needed

In *Witt*, the debtor had scheduled a car with no equity and claimed an exemption of \$4,025. No objection was filed to this exemption. Thereafter, the Trustee avoided the lien on the car and requested turnover of the vehicle from the debtor. The debtor objected, claiming the Trustee's failure to timely contest the exemption insulated the car from any interest of the estate. However, the court found that the Trustee's failure to object could not defeat the Trustee's right to preserve the avoided lien for the benefit of the estate. Judge Martin held:

The exemption, though valid by default, attached only to the debtor's interest in the car on the petition date. The equity later created by the Trustee's lien avoidance did not exist on the effective date of the exemption. It could be claimed only under § 522(g) which is unavailing to the debtor. Accordingly, the Debtor was ordered to surrender the vehicle to the trustee.

**K.** Debtor cannot Exempt Property Re-conveyed Post-petition

Debtor's residence had been titled jointly with his non-debtor spouse until February 2008, when debtor gifted his interest to his wife. Debtor filed a Chapter 7 petition on May 18, 2009. Although he had no interest in the home on the petition date, he scheduled ownership of the residence and claimed a homestead exemption therein. He did not disclose the February 2008 transfer. At the 341 meeting, the trustee indicated his intent to avoid the transfer through litigation. The following month, debtor's wife re-conveyed the transferred interest back to the debtor, who then filed amended schedules to disclose all the transfers related to the home. The trustee filed an objection to the exemption claimed in the home under § 522(g). Debtor defended by arguing that the re-conveyed interest was not "recovered" by the trustee and therefore § 522(g) was inapplicable. The bankruptcy court sustained the trustee's objection. *In re Floyd*, 423 B.R. 579 (Bankr. M.D. Ga. 2009). First, the court noted that the post-petition re-conveyance did not render the home property of the estate on the petition date. Instead, it would only become property of the estate under § 541(a)(3) by virtue of the trustee's recovery under § 550. Section 522(g)(1) specifically bars exemptions in "property that the trustee recovers under section ... 550" following the voluntary transfer. Judge Walker further noted that §§ 550(a) and 548 did not require that the trustee bring an adversary proceeding to avoid a transfer and to recover the property transferred. While the court noted that an adversary proceeding was the appropriate method for a trustee to enforce his rights when meeting resistance from the transferee, such a proceeding is not necessary where the transferee concedes the trustee's superior claim on the property. The court specifically followed

*Glass v. Hitt (In re Glass)*, 60 F.3d 565 (9<sup>th</sup> Cir. 1995), which also involved a property re-conveyed to the debtor post-petition, just days after a trustee filed his objection to exemptions. Thus, the court held that § 522(g)(1) would prevent the debtor from exempting the re-conveyed property which entered the bankruptcy estate via § 541(a)(3), and the re-conveyance back to debtor is “immaterial to the trustee’s rights.”

## XI. MISCELLANEOUS ISSUES OF INTEREST

### A. Consequence of Filing Exemption Claims Late

1. When a debtor files his bankruptcy disclosure forms, including his Schedule C, outside of the time limits of Rule 1007(c), he forfeits the benefit of the bar date provided by Rule 4003(b).

2. In *Petit v. Fessenden*, 80 F.3d 29 (1st Cir. 1996), the debtor’s creditors initiated an involuntary Chapter 7 proceeding in the United States Bankruptcy Court for the District of Maine, and the bankruptcy court entered the order for relief on December 10, 1993. *Petit v. Fessenden*, 80 F.3d 29, 30 (1st Cir. 1996). Approximately 1 week later, the debtor filed a motion to convert the case to a case under Chapter 11. At the resulting hearing on February 2, 1994, over the objection of the petitioning creditors, the court converted the case to a case under Chapter 11, and took under advisement a request to appoint a Chapter 11 trustee. The resulting order required the debtor to file her Chapter 11 bankruptcy disclosure forms on February 23, 1994. Two days after this deadline, and 61 days after her bankruptcy disclosure forms were due in the original Chapter 7 case under Rule 1007(c), the debtor filed her disclosure forms, including her Schedule C.

On the debtor’s schedule C, the debtor claimed an exemption in the entire anticipated proceeds from a lawsuit against Key Bank, which the debtor estimated had a value greater than \$25 million. On May 17, 1994, the United States Trustee convened the meeting of creditors, which the Assistant United States Trustee continued to an unspecified date. On June 17, 1994, the court appointed a Chapter 11 Trustee. On August 22, 1994, two months after his appointment, the Chapter 11 Trustee objected to the debtor’s claim of exemptions. Following a response in opposition along with a motion to quash, the bankruptcy court ruled that the objection to exemptions was not time barred. The district court later affirmed, and the debtor appealed to the First Circuit. After evaluating the interplay between Rules 1007 and 4003 and 11 U.S.C. § 522, the First Circuit affirmed the lower courts’ decisions on the premise that the debtor could not object to the timeliness of the objection because she had not complied with the time limits under Rule 1007(c) or the bankruptcy court’s order.

3. In *In re Montanoro*, 307 B.R. 192 (Bankr. E.D.Cal 2004) (Kline, J.), the bankruptcy court synthesized the holding from *Petit* with Supreme Court precedent to conclude that for a debtor to enforce time limits in the rules, the debtor must first comply with the rules. The debtors in that matter commenced their bankruptcy case by filing a skeletal Chapter 7 petition for relief on September 25, 2003. As a result, the deadline for them to file their bankruptcy disclosure forms under Rule 1007(c) was October 9, 2003. After that date on

October 21, 2003, the debtors filed their bankruptcy disclosure forms, including their Schedule C. The meeting of creditors began and was completed on October 28, 2003. On November 13, 2003, the debtors filed a motion to compel requesting an order compelling the trustee to abandon the estate's interest in their residence. The trustee opposed the debtors' motion arguing that their tardiness in filing Schedule C resulted in the debtors forfeiting their right to claim any exemptions at all.

The court in *Montanoro* disagreed with the trustee reasoning that his argument was too harsh and "unduly punitive if applied as a general rule." *Id.* at 198. Instead, the court reviewed the rules of law set forth by the Supreme Court in *Taylor v. Freeland & Kronz*, 503 U.S. 638 (1992) and *Kontrick v. Ryan*, 540 U.S. 443 (2004) and by the First Circuit in *Petit*, 80 F.3d at 32-33 and concluded that, when taken together, they stand for the "proposition that one who does not honor time requirements created by claim-processing rules in the Federal Rules of Bankruptcy Procedure may forfeit benefits that would otherwise flow from such rules." *Montanoro*, 307 B.R. at 198-199. As a result, the debtors' late filed Schedule C did not forfeit debtors' right to claim exemptions, but instead forfeited "the protection of the limitations period granted by Rule 4003(b). . . ." *Id.* at 199.

#### B. Untimely Objection Sustained Where Exempted Property Not Property of the Estate

Debtors scheduled and then exempted their fee simple interest in certain real property consisting of 60 acres and improvements valued at \$500,000, under their Idaho exemption. The Trustee later learned that the property was actually owned by the debtor's LLC. Neither the Trustee nor any other party objected to the exemption within the required 30-day period under Rule 4003(b). Thereafter, debtors filed a motion to compel abandonment of the property, which the Trustee opposed. *In re Lavelle*, 350 B.R. 505 (Bankr. D. Idaho 2005). Debtors relied on *Taylor v. Freeland & Kronz*, 503 U.S. 638 (1992), wherein the Supreme Court held the failure to object bars the party from contesting the exemption later "whether or not [debtor] had a colorable statutory basis for claiming it." The Trustee, however, distinguished the case by reference to § 522(b) which only allows an exemption from "property of the estate." Trustee asserted that the subject property was not property of the estate and that the failure to object to the claimed exemption was not fatal. The bankruptcy court agreed. Judge Myers noted that it was the debtor's interest in their LLC, not the assets of the LLC, that became property of the bankruptcy estate, and debtors had claimed no interest therein as exempt. Therefore, the Trustee's objection was sustained.

## XII. CARVE-OUTS AND SUBORDINATION

#### A. Background

The trustee is sometimes able to administer a property with no equity. Under § 724(b), certain rights are given to the trustee to subordinate tax claims to the cost of the administration of the estate. In *Laredo, supra*, that is what the trustee was accomplishing. In other instances, the trustee works out a carve-out with the IRS or other state taxing authorities with respect to their tax liens, or with respect to a mortgage holder on the property. If the property is successfully sold, the trustee may realize on the carve-out for the benefit of the bankruptcy estate. If a debtor

has asserted an exemption or later amends to claim an exemption in the carved-out portion of a homestead exemption, the homestead exemption has nothing to which it can attach if no equity position is reached. Typically, the trustee's carve-out is calculated against the mortgagee's payoff and is not representative of any equity. Thus, it is outside the scope of the homestead exemption. *See, e.g., In re Moyer*, 39 B.R. 211 (Bankr. N.D. Ga. 1984)(Drake, J.).

1. Home with No Equity can be sold by Trustee on Carve-out with the IRS despite Debtor's Claimed Exemptions

Debtors owned a residence with a value of \$325,000. A first mortgage encumbered it in the approximate amount of \$195,500 followed by a federal tax lien in the approximate amount of \$382,300. Although there was no equity in the property, debtors claimed under North Carolina law a homestead exemption of \$60,000 indicating "debtors exempt their entire interest in this property despite the lack of equity." The trustee objected on the ground that debtors had no equity in the residence to exempt. The bankruptcy court overruled the objection but noted that title to the home remained with the bankruptcy estate under § 541. The trustee negotiated a carve-out with the IRS whereby 30% of the sale proceeds that would otherwise be paid to the IRS toward satisfaction of its tax lien would instead be retained by the bankruptcy estate for payment of allowed administrative claims, with any balance to be paid on a pro-rata basis to unsecured creditors. Trustee then filed a motion to sell the property pursuant to that carve-out. Debtors objected on the ground that their exemption claim had removed the residence from the bankruptcy estate such that the trustee lacked statutory authority to sell it. The bankruptcy court denied the objection and granted the motion. Debtors appealed. The district court affirmed. On further appeal to the circuit court, the lower court was affirmed. *Reeves v. Callaway (In re Reeves)*, 2013 U.S. App. LEXIS 23358 (4<sup>th</sup> Cir. Nov. 20, 2013). The Fourth Circuit noted that the fully encumbered property remained the property of the bankruptcy estate until it was either abandoned or sold by the secured creditor after obtaining stay relief. The fact that the IRS had agreed to the carve-out had no adverse consequences for debtors because the trustee confirmed that debtors would receive full credit with respect to their indebtedness to the IRS for any amount paid under the carve-out to the bankruptcy estate. This arrangement justified the trustee's action in selling the residence as opposed to abandoning it. Further, the court held that the debtors' exemption of \$60,000 was subordinate to the first mortgage lien and the federal tax lien. Therefore, effectively, there was no value to which the exemption could attach.

[*Author's Comment:* NABT and NACBA filed competing amicus briefs with NABT prevailing. Congratulations to Marty Sheehan who prepared the brief and appeared on behalf of NABT, as well the entire Amicus Committee. This is an important case because some courts do not understand that the lien position from which the carve-out proceeds are obtained is not subject to the subordinate exemption rights of the debtors. This case makes clear that not only does the trustee have the right to sell the property notwithstanding the exemption claim but that the estate's interest in the carve-out comes ahead of those same exemption claims.]

2. Short Sale Incentive Belongs to Estate

On her petition date, debtor's mortgage was far greater than the value of her home. She nevertheless claimed as exempt "any and all proceeds, revenues, or concessions conceded to or

granted by the secured mortgage lender on the property" up to \$11,764. Trustee objected, and the court sustained the trustee's objection. *In re BonnieJean Bunn-Rodemann*, 491 B.R. 132 (Bankr. E.D. Cal. 2013). Judge Sargis stated: "Attempting to claim an exemption in this type of asset is a relatively new phenomenon arising from creditors realizing that a short sale of the property securing the debt (by which the creditor agrees to take less than the full amount owed) is better than the creditor completing a non-judicial foreclosure sale and the creditor becoming the owner of the property." The court explained that some "savvy" borrowers were negotiating incentive payments from the lenders that would be less than the cost of foreclosing, owning the property, and selling the property itself. Further, Chapter 7 trustees had determined that they could obtain incentive payments by conducting short sales of homes rather than abandoning them. When they did so, the incentive payment would not be the liquidation of the asset that the debtor owned on the petition date but, rather, compensation paid by the secured creditor to the trustee for services rendered. However, once the Chapter 7 petition was filed, the debtor no longer had the right or power to conduct a short sale or to "sell her own real estate services." "It is the Chapter 7 Trustee's labor and the estate's expense in working to sell property of the estate which is the subject of the incentive payment." The court observed that when the trustee chose to retain and attempt a sale of the underwater home, the debtor had the option of moving out, asking the trustee to abandon the property, or attempting to stay and negotiating with the trustee the terms of continued possession, such as paying the current insurance and maintenance costs to allow the debtor to avoid paying rent for housing and moving expenses during the first months of a Chapter 7 fresh start. The court observed: "In reality, these debtor-trustee issues concerning a short sale are steeped in the highest tradition of bankruptcy – what deal can be made that is in everyone's best interest."

[*Author's Comment:* This court's analysis seems to state the obvious, particularly with its last comment concerning the deal being made "in everyone's best interest." Nevertheless, in certain regions, the U.S. Trustee objects to efforts to do short-sales or carve-outs, despite the win-win-win scenario, if it feels the trustee and his or her professionals receive a disproportionate amount of benefit when compared to the general unsecured creditors. No assessment of the risk borne by the trustee is part of the calculation nor does it seem to matter that every unsecured creditor would prefer a meaningful distribution rather than no distribution.]

3. Holding Permits Debtor to Exempt Carve-out Proceeds (creating a conflict with other cases)

The trustee believed that she could obtain carve-outs from the mortgage holders on two separate properties. After debtor had received a discharge, trustee filed an application to employ a bankruptcy short sale specialist. In response, the debtor filed an amended Schedule C asserting wild-card exemptions in the properties in the total amount of \$26,328. Trustee asserted that the debtor could not do so as those exemptions would not have existed on the petition date and exceeded the maximum amount permitted under California law. The court sustained the objection only as to the amount claimed as it was beyond the wild-card limit of \$23,350, but otherwise overruled the objection. *In re Wilson*, 494 B.R. 502 (Bankr. C.D. Cal. 2013)(Clarkson, J.) The court stated that it did not matter how the funds were generated by the estate through a § 363 sale, including if derived from a "gift" from the mortgage lender so that they would not have to undertake a foreclosure proceeding under California law. Those funds were subject to the

valid exemption asserted in this case. *Contra, In re Bunn-Rodemann*, 491 B.R. 132 (Bankr. E.D. Cal. 2013); *In re Baldrige*, 2013 WL 1759365, 2013 U.S. Dist. LEXIS 58512 (E.D. Mich. 2013); *In re Reeves*, 2013 U.S. App. LEXIS 23358 (4<sup>th</sup> Cir. Nov. 20, 2013), and *In re Goben*, 2013 WL 5302798, 2013 BANKR. LEXIS 3952 (8<sup>th</sup> Cir. BAP 2013).

[*Author's Comment*: The court misunderstands the exemption in part because the trustee did not properly assert the objection. There is no equity in the properties to exempt as this is a gift from the lenders to the estate that bypasses debtor's exemption rights. Many cases so hold but none were discussed by the court or apparently asserted by the trustee here. It is also possible that the trustee did not properly document the nature of the carve-out which led to this result. The amount carved-out should be deducted dollar for dollar from the mortgage holder's lien to reflect that the trustee is standing in the shoes of the mortgage holder for purposes of the carve-out amount which would not be subject to exemption for that reason.]

4. Homestead Exemption does not attach to “carve-out” from Sale Proceeds

In *In re Diener*, 2015 WL 4086154 (Bankr. N.D. Ga. 2015) (Murphy, J.), debtors asserted a claim of exemption in their homestead to which no objection was filed. Debtors were unable to make their mortgage payments and were in danger of losing their home to foreclosure. The trustee stepped in and reached a carve-out settlement with the mortgage holder to allow for a short-sale of the property and a carve-out of the sale proceeds from the payoff of the mortgage. The estate received over \$25,000 as part of the carve-out. Debtors did not object to the carve-out settlement or §363 sale motion, both of which asserted that the proceeds would be non-exempt as being part of the mortgage and not equity. When the trustee filed his final report reflecting that no exemption funds would be paid on the property sale, debtors objected asserting that their homestead exemption primed the carve-out proceeds. Following the overwhelming majority of cases on the subject, the court overruled the objection and granted the final report, finding that the homestead exemption would only attach to equity from the sale of the property. As there was no equity, the exemption could not be monetized. [*Author's Comment*: In *In re BonnieJean Bunn-Rodemann*, 491 B.R. 132 (Bankr. E.D. Cal. 2013). Judge Sargis stated: "In reality, these debtor-trustee issues concerning a short sale are steeped in the highest tradition of bankruptcy – what deal can be made that is in everyone's best interest." Judge Sargis seems to state the obvious that the deal being made is "in everyone's best interest." Nevertheless, in certain regions, the U.S. Trustee objects to efforts to do short-sales or carve-outs, despite the win-win-win scenario, if it feels the trustee and his or her professionals receive a disproportionate amount of benefit when compared to the general unsecured creditors. No assessment of the risk borne by the trustee is part of the calculation nor does it seem to matter that every unsecured creditor would prefer a meaningful distribution rather than no distribution.]

### XIII. DOMESTIC SUPPORT OBLIGATIONS

#### A. Background

Section 523(a)(5), as amended, excepts from discharge any debt for a domestic support obligation. Therefore, under § 522(c)(1), debts for DSO's may be enforced against exempt

property, whether or not the underlying support obligation could be enforced against that property under applicable state law. Additionally, under § 507(a)(1) (A), DSO claims now have first administrative priority. However, to protect a trustee's ability to recover his or her administrative expenses for administering assets to pay these now highest priority claims, Congress added § 507(a)(1)(C) which provides, in pertinent part:

If a trustee is appointed ... the administrative expenses of the trustee ... shall be paid before payment of [DSO claims] to the extent that the trustee administers assets that are otherwise available for the payment of [DSO claims].

*See, generally*, Dennis G. Bezanson & Gary B. Rudolph, "The Super-Priority" of a "Domestic Support Obligation" (DSO: The Trustee as Liquidator of Exempt Property for the Benefit of DSO Claimants; and Other DSO Issues, *NABTalk*, Vol. 22, No. 1 (2006) (hereafter the "NABTalk Article.")

B. The Issues Raised

1. Is the Trustee Required to Object to Claimed Exemptions In Order to Preserve Otherwise Exempt Property for the Benefit of a DSO Claimant?
2. May the Trustee Liquidate Exempt Property for the Benefit of a DSO Claimant:
3. Do the BAPCPA amendments to §§ 507(a)(1) and 522(1) Authorize a Trustee to Administer Exempt Property?

Right after BAPCPA, several decisions have now considered the foregoing issues and answered them in the negative, including *In re Covington*, 2006 WL 2734253 (Bankr. E.D. Cal.) (McManus, J.); *In re Ruppel*, 2007 WL 108941 (Bankr. D. Ore.) (Alley, J.); *In re Quezada*, 2007 WL 438258 (Bankr. S.D. Fla.) (February 7, 2007) (Mark, J.); and *In re Van Deventer*, 2007 WL 1175734 (Bankr. C.D. Ill. 2007) (Gorman, J.).

C. Is the Trustee Required to Object to Claimed Exemptions in Order to Preserve Otherwise Exempt Property for the Benefit of a DSO Claimant?

It appears that it is not necessary for a trustee to object to claimed exemptions in order to preserve otherwise exempt property for the benefit of a DSO claimant. This is good news for trustees, relieving trustees of a potential threat of liability for any failure to object.

[A] domestic support obligation may be enforced against property of the debtor, both during the chapter 7 case without violation of the automatic stay, and after entry of a discharge without violation of the discharge injunction. *See* 11 U.S.C. §§ 362(b)(2)(B) & 522(c)(1). This is so even when the property against which the domestic support obligation is being enforced has been exempted by the debtor in the bankruptcy case.

*Covington* at p. 2.

Citing *Ruppel* and *Covington*, *Quezada* likewise finds no authority for any limitation of a debtor's right to claim all exemptions otherwise available under § 522 and that § 522(c)(1) does not create a valid basis for an objection to exemptions by the trustee or the DSO creditor. *Quezada* at p. 4.

D. May the Trustee Liquidate Exempt Property for the Benefit of a DSO Claimant? Do the BAPCPA amendments to §§ 507(a)(1) and 522(c)(1) Authorize a Trustee to Administer Exempt Property?

1. Overview

All of the cases to have addressed this issue were pre-*Schwab v. Reilly* and involved fact situations where the trustee was attempting to administer for the benefit of a DSO claimant fully exempt assets. Section 704(a)(1) provides that a chapter 7 trustee must “collect and reduce to money property of the estate....” (*Emphasis added.*) Those assets might not be considered fully exempt under *Schwab*.

2. *Covington*

When a debtor exempts property, it is effectively removed from the estate.... Therefore, there is no ‘property of the estate’ for the trustee to administer for the benefit of creditors in general or the holder of the domestic support obligation in particular.

*Covington*, at p. 2.

The *Covington* court also added a policy argument:

[I]t makes more sense to require the holder of a domestic support obligation claim, not the bankruptcy trustee, to enforce a domestic support obligation in a non-bankruptcy forum. That forum may then deal with the availability and extent of non-bankruptcy exemptions.... By enforcing the domestic support obligations in state court, the trustee's administrative expenses will be avoided.

*Covington* at p. 3.

3. *Ruppel*

Following *Covington*, and noting that the asset to be administered was claimed as fully exempt, the *Ruppel* court held:

The Trustee seeks to liquidate exempt non-estate property which is not owed to the estate or unsecured creditors generally, for the benefit of a single creditor. This the Trustee may not do, as ‘there is nothing in ... the liquidation framework of the Code authorizing a chapter 7 trustee to collect money not owed to the estate.’

*Ruppel* at p.3 citing *Williams v. California First Bank*, 859 F.2d 664, 667 (9<sup>th</sup> Cir. 1988)

4. *Quezada*

Here the Trustee argued that exempt assets were “assets that are otherwise available for payment of DSO claims” and thus, within the scope of assets Congress intended trustees to administer under § 507(a)(1)(C). The Trustee further argued that Congress could have used the phrase “property of the estate” instead of the broader phrase “assets otherwise available.” The Trustee cited as authority the *NABTalk* Article.

However, the court found that these arguments were trumped by the § 704(a)(1) limitation that trustees administer “the property of the estate.” The court found that the fully exempt asset had been removed from property of the estate.

The phrase “assets otherwise available ... is not express authority for a trustee to administer exempt property.” The court finds that a DSO creditor can enforce directly in the bankruptcy court a DSO claim against property, as a proceeding arising under Title 11. Thus, jurisdiction would be created under § 1334(b).

E. Where Does This Leave Trustees?

The analysis of these cases were likely overturned by *Schwab v. Reilly* because the asset is not being removed from the estate as the exemption is now dollar limited. Trustees are not required to object to the otherwise properly claimed exemption of an asset for the sole purpose of administering it for the benefit of a DSO claimant.

Are there situations where the Trustee would have a higher likelihood of success? Yes.

- a. Consider what would be the analysis of these courts if the assets the Trustee sought to administer were property of the estate because they

consisted of equity above the exempted amounts. In such a situation, the Trustee would be required to administer those assets under § 704. If the assets were sold but generated only enough money to pay the secured liens, administrative expenses, and the exemption, would the exemption portion be paid to the debtor or the DSO claimant? The author would suggest to the DSO claimant under §522(c)(1).

- b. The DSO claimant could even obtain a judgment post-petition without violating the stay under §§ 362(b)(2)(B) and (C) that it would be entitled to collect from property that is not property of the estate and even try to garnish the Chapter 13 trustee. *See In re Brickell*, 292 B.R. 705 (Bankr. S.D. Fla. 2003)(Schermer, J.), *aff'd* 142 Fed.Appx. 385 (11<sup>th</sup> Cir. July 29, 2005). Thus, if this kind of demand is made, the trustee would be put in a very difficult position.

APPENDICES

A. *SCHWAB v. REILLY*

B. ARTICLE: *LAW v. SIEGAL* DICTA LEADS LOWER COURTS ASTRAY

C. *LAW v. SIEGAL*

***Schwab v. Reilly Two Years Later: Appellate Opinions on Appreciation and 100% of FMV***

Prior to *Schwab v. Reilly*, debtors in many jurisdictions signaled intent to remove an asset from the bankruptcy estate by exempting a dollar amount equal to the amount listed as the full fair market value of the asset.<sup>1</sup> In *Schwab*, however, the Supreme Court ruled such a practice only exempted the debtor's interest in the asset to the extent of the exemption claimed.<sup>2</sup> Therefore, because the debtor in *Schwab* undervalued the asset, the trustee could sell the asset for the benefit of the estate.<sup>3</sup> In dicta, the Supreme Court stated that if the debtor wanted to exempt the full value of an asset, the intent would have to be unambiguous.<sup>4</sup> Thus, after *Schwab*, much debate has focused on the appropriate way for a debtor to signal his intent to exempt the entire asset from the estate. A recent Third Circuit decision, *In re Orton*, highlights the difficulty in removing an asset from the bankruptcy estate through a claim of exemption.<sup>5</sup>

Appreciation Remains in the Estate

In *Orton*, the Third Circuit made clear that the method employed pre-*Schwab* does not operate to wholly exempt an asset from the estate even where the amount listed represents the actual, fair market value of the asset.<sup>6</sup> In *Orton*, the debtor listed his one-eighth interest in vacant land, which was subject to an oil and gas lease, as well as his one-fourth interest in the oil and gas lease, assigning a fair market value of \$4,250 and \$1, respectively.<sup>7</sup> The debtor noted on his schedules that no well had been drilled on the vacant land and that no royalties were

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1 130 S. Ct. 2652 (2010).

2 *Id.* at 2662.

3 *Id.*

4 *Id.* at 2668.

5 2012 U.S. App. LEXIS 14898 (3d Cir. July 20, 2012).

6 *Id.* at \*2.

7 *Id.*

currently due under the lease.<sup>8</sup> The debtor then claimed wildcard exemptions for the two interests, pursuant to 11 U.S.C. § 522(d)(5), and claimed as exempt the full amount of their value—\$4,250 and \$1.9 No party filed an objection to the claimed exemptions within the 30-day period prescribed by Rule 4003.<sup>10</sup>

The chapter 7 trustee subsequently filed a motion to close the case, but to except the debtor's royalty interest in the oil and gas lease from abandonment, thereby preserving her ability to recover any future royalties for the benefit of the estate in the event a well was ever drilled on the property.<sup>11</sup> The debtor objected, arguing that he had successfully removed the lease from the estate by listing its actual, fair market value, which value fell within the exemption limit.<sup>12</sup> The bankruptcy court and district court disagreed, ruling that the debtor had exempted only an interest in the asset and that the trustee was entitled to pursue any post-filing appreciation of value of the oil and gas lease above the amount explicitly stated as exempt in Schedule C.

On appeal to the Third Circuit, the debtor argued that *Schwab's* holding should be “confined to instances of debtor malfeasance or negligence in claiming exemptions” and should be applied in only those cases where the actual value of the assets exceed either (a) the debtor's estimates of fair market value or (b) the statutory limit for exemption.<sup>13</sup>

The Third Circuit rejected the debtor's argument, stating that “there is no indication in *Schwab* that the Court meant to carve out an exception that would benefit only debtors who are accurate (and lucky) enough to estimate and exempt an asset's exact fair market value.”<sup>14</sup>

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<sup>8</sup> *Id.*

<sup>9</sup> *Id.* at \*2.

<sup>10</sup> *Id.* at \*3.

<sup>11</sup> *Id.*

<sup>12</sup> *Id.*

<sup>13</sup> *Id.* at \*9.

<sup>14</sup> *Id.* at \*12.

Rather, “*Schwab* focused on the concerns about placing trustees on notice, not concerns about inaccurate debtor valuations.”<sup>15</sup> “[T]he [Supreme] Court was clear that exemptions under § 522(d)(5) are presumed to preserve a debtor’s ‘interest’ in an asset rather than the asset itself; a debtor seeking to retain more than an ‘interest’ must indicate that fact unambiguously in the Schedules.”<sup>16</sup> “To do this, the Supreme Court “enumerated the specific actions that would manifest intent to exempt an entire asset.”<sup>17</sup> Namely, the Supreme Court stated that the debtor “could make the scope of the exemption clear . . . by listing the exempt value as ‘full fair market value (FMV)’ or ‘100% of FMV.’”<sup>18</sup> The Third Circuit went on to conclude that “when a debtor retains only an interest in an asset, rather than the asset itself, the debtor is limited to the value of exemption; the estate is entitled to any appreciation in the asset’s value beyond the amount exempted.”<sup>19</sup>

#### Whether Objection to 100% of FMV is Mandatory

As recognized by the Third Circuit, however, even if the *Orton* debtor had used the Supreme Court’s suggested language, the result likely would have been the same.<sup>20</sup> In *Schwab*, “the Court warned, ‘it is far from obvious that the Code would ‘entitle’ [a debtor] to clear title in [an asset] even if she claimed as exempt a ‘full’ or ‘100%’ interest in it.’”<sup>21</sup> This warning has come to fruition in the majority of cases that have considered the issue, as the “courts addressing the effect of claiming as exempt ‘100% of FMV’ of an asset (or similar words) have held that using these phrases either renders the attempted exemption facially defective or invites an evidentiary hearing to determine the fair market value of the asset so that a dollar amount can be

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<sup>15</sup> *Id.* at \*11.

<sup>16</sup> *Id.* at \*12 (quoting *Schwab*, 130 S. Ct. at 2668, n. 21).

<sup>17</sup> *Id.*

<sup>18</sup> *Schwab*, 130 S. Ct. at 2668.

<sup>19</sup> *Orton*, 2012 U.S. App. LEXIS 14898 at \*16; see also *Gebhart v. Gaughan*, 621 F.3d 1206 (9th Cir. 2010).

<sup>20</sup> *Id.* at \*15-16, n. 1.

<sup>21</sup> *Id.* at \*13-14 (quoting *Schwab*, 130 S. Ct. at 2668).

assigned to the exemption.”<sup>22</sup> Those cases “reason that ‘where the statutory basis for a debtor’s claim of exemption provides only for an exemption of an interest in a certain property up to a specific dollar amount, the ‘value of claimed exemption’ must be identified as a monetary value.”<sup>23</sup> However, those cases also hold that the trustee must object to preserve the estate’s interest in the asset.

For example, in *In re Stoney*, the court interpreted the effect of claiming a “100% of FMV” exemption in assets under Virginia’s exemption scheme.<sup>24</sup> Virginia, like the majority of states, has opted out of the federal exemption scheme and the *Stoney* court found that the trustee’s objection to the debtor’s claim of exemption in 100% of FMV should be sustained where the Virginia Code contains a monetary limitation.<sup>25</sup> The court stated:

Remembering the gravamen of *Schwab* concerns whether and when a trustee must object to a claimed exemption to preserve the right to subsequently liquidate an exempted asset, it is a misreading of *Schwab* to conclude the Court has blessed the use of a designation such as “100% of FMV” as a valid and unobjectionable scheduling of a claimed exemption value where the relevant exemption statute, such as the Virginia Code, expressly limits the exemption to a maximum case value.<sup>26</sup>

The court added that to interpret *Schwab* as to negate the specific requirements of the applicable body of law “would permit a judicial superseding of the state statutory requirements for exemptions and functionally negate the express authority of a state to opt out and impose its exemption limitation . . . on debtors who are citizens of opt-out states.”<sup>27</sup>

The *Stoney* court, however, denied the trustee’s request that it establish a bright line rule “that a trustee is not required to object to exemptions where a debtor claims the value of the

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<sup>22</sup> *Id.* at \*15 (citing to *In re Luckham*, 464 B.R. 67, 77 (Bankr. D. Mass. 2012); *Massey v. Pappalardo*, 465 B.R. 720 (B.A.P. 1st Cir. 2012); *In re Stoney*, 445 B.R. 543, 552 (Bankr. E.D. Va. 2011); *In re Moore*, 442 B.R. 865, 866 (Bankr. N.D. Tex. 2010)).

<sup>23</sup> *Id.*

<sup>24</sup> 445 B.R. at 550-54.

<sup>25</sup> *Id.* at 546, 554.

<sup>26</sup> *Id.* at 552.

<sup>27</sup> *Id.*

exemptions as 100% of fair market value in order to limit the exemptions to the statutory amounts set forth in the Virginia Code.”<sup>28</sup> The court found that *Schwab* “mandate[s] that if a debtor claims the value of an exemption the trustee believes is improper or invalid, whether as to form or substance, the trustee must object to preserve the right to subsequently liquidate the asset at issue.”<sup>29</sup> According to *Schwab*, “[r]equiring a trustee to object to exemptions ‘facilitate[s] the expeditious and final disposition of assets, and thus enable[s] the debtor (and the debtor’s creditors) to achieve a fresh start free of the finality and clouded-title concerns [the *Schwab* debtor] describes.”<sup>30</sup>

Therefore, although the *Orton* court suggested that the outcome of its decision would have been the same had the trustee been put on proper notice of the debtor’s intent through the use of “100% of FMV,”<sup>31</sup> other courts indicate that an objection in such a circumstance is mandatory in order to preserve the estate’s interest in the asset.

#### No Amendment to Official Form 6C

In response to *Schwab*, the Bankruptcy Rules Advisory Committee had proposed an amendment to Official Form 6C to change the column for value of claimed exemption by providing the debtor two options: one that says “exemption limited to \$\_\_\_\_\_” and the other that says “full fair market value of the exempted property;” and the debtor would be instructed to “check one box only for each claimed exemption.”<sup>32</sup> The Committee explained its proposed amendment, stating that “in considering the impact of *Schwab* on Schedule C, the Committee notes that the current form does not indicate the right of a debtor to exercise the option described

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<sup>28</sup> *Id.* at 554.

<sup>29</sup> *Id.* at 555.

<sup>30</sup> *Id.*

<sup>31</sup> 2012 U.S. App. LEXIS 14898, \*15-16, n. 1; *see also Massey*, 465 B.R. at 726.

<sup>32</sup> Bankruptcy Rules Advisory Committee, Report of the Advisory Committee on Bankruptcy Rules to the Standing Committee on Rules of Practice and Procedure, *available at* <http://www.uscourts.gov/RulesAndPolicies/FederalRulemaking/PublishedRules.aspx>, at pp. 15-16 (May 6, 2011).

by the Supreme Court of exempting the full fair market value of an asset.”<sup>33</sup> The Committee’s suggestion was spawned from “concern that only knowledgeable debtors (or more likely, debtors represented by knowledgeable lawyers) would understand that ‘value of claimed exemption’ could be stated in something other than a specific dollar amount.”<sup>34</sup>

However, as recognized by *Orton* and by the majority of courts that have ruled on this issue, unless the statute provides an in-kind exemption, the debtor does not have the right to exempt 100% of FMV of the asset, but must state in dollar amount the extent of his exemption.<sup>35</sup> This point was unequivocally made by the First Circuit Bankruptcy Appellate Panel in *Massey v. Pappalardo*, where it flatly rejected the argument that *Schwab* “supports a debtor’s retention of ‘exempt property regardless of whether the relevant exemption statute includes a monetary cap or not’” and that such a policy is “necessary to give meaning and effect to a debtor’s ‘fresh start.’”<sup>36</sup> Rather, the *Massey* court found that *Schwab* was not “outlining a procedure by which an exemption claimed under a limited-interest exemption statute could be legitimately converted into an exemption in-kind”<sup>37</sup> and that the Supreme Court found that such policy would actually “threaten to convert a fresh start to a free pass,” stating:

Congress balanced the difficult choices that exemption limits impose on debtors with the economic harm that exemptions visit on creditors, and it is not for us to alter this balance by requiring trustees to object to claimed exemptions based on form entries beyond those that govern an exemption’s validity under the Code.<sup>38</sup>

The bankruptcy rules committee apparently agreed and has dropped the proposed amendment.

## Conclusion

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<sup>33</sup> *Id.*

<sup>34</sup> *Id.*

<sup>35</sup> *Orton*, 2012 U.S. App. LEXIS 14898; *In re Luckham*, 464 B.R. 67, 77 (Bankr. D. Mass. 2012); *Massey v. Pappalardo*, 465 B.R. 720 (B.A.P. 1st Cir. 2012).

<sup>36</sup> 465 B.R. at 724, 729.

<sup>37</sup> *Id.* at 727-728 (quoting *In re Luckham*, 464 B.R. 67, 74 (Bankr. D. Mass. 2012)).

<sup>38</sup> *Id.* at 729-30 (quoting *Schwab*, 130 S. Ct. at 2667).

Thus, while a majority of courts recognize that a claim of 100% of FMV is facially invalid with respect to exemptions limited to a specific dollar amount and sustains a trustee's objection if one is lodged, *Schwab* requires that the objection be made. Further, although such objections by the trustee could be avoided if debtors simply claim exemptions in a numerical amount within the statutory exemption limits, that practice no longer operates to exempt the entire asset even if, as in *Orton*, the debtor provides the actual, fair full market value of the asset. Thus, the Supreme Court's suggestion actually encourages gamesmanship, while discouraging finality and prompt administration. On the one hand, it encourages debtors to claim exemptions in a procedurally defective manner, thereby requiring the trustee to object. On the other hand, where debtors actually claim exemptions correctly, it leaves the asset in the bankruptcy estate and places post-petition appreciation at risk to future administration by the trustee. The solution, of course, is to look to another section of the Bankruptcy Code that already provides a mechanism by which the debtor can remove assets from the bankruptcy estate. Under Section 554, the debtor could request that the trustee abandon the asset or could file a motion to compel abandonment with the bankruptcy court. This procedure, not attempting to remove an asset from the estate through a claim of exemption, would allow the debtor to obtain finality and prompt administration.

**B. ARTICLE: LAW v. SIEGAL DICTA LEADS LOWER COURTS ASTRAY**

# Trustee Talk

BY NEIL C. GORDON AND JONATHAN H. AZOFF

## Law v. Siegel Dicta Leads Lower Courts Astray

**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.



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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*<sup>1</sup> 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*,<sup>2</sup> 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."<sup>3</sup> 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.<sup>4</sup>

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."<sup>5</sup> 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*<sup>6</sup> that such exemptions were not acceptable. In *Schwab*, the debtor had valued her kitchen equipment and claimed an exemption in the same dollar amount (an "in-kind exemption").<sup>7</sup> 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.<sup>8</sup> The lower courts all ruled in the debtor's favor,<sup>9</sup> 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.<sup>10</sup> 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.<sup>11</sup> 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.

4 444 F.3d 643-44.  
5 444 F.3d 644.  
6 130 S. Ct. 2162 (2010).  
7 444 F.3d 657.  
8 444 F.3d 656.  
9 444 F.3d 658.  
10 444 F.3d 651-62.  
11 444 F.3d 655-66.

1 134 S. Ct. 1156 (2014).  
2 503 U.S. 639 (1992).  
3 444 F.3d 643.

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.<sup>12</sup> 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,<sup>13</sup> and perhaps even sanctionable.<sup>14</sup> 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.<sup>15</sup> The debtor had scheduled a second mortgage for \$156,929 in favor of Lily Lin of China that he had forged.<sup>16</sup> 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.<sup>17</sup> The bankruptcy court granted the surcharge motion and ordered the debtor's entire \$75,000 homestead exemption surcharged.<sup>18</sup> The Bankruptcy Appellate Panel (BAP) affirmed the surcharge in an unpublished opinion.<sup>19</sup>

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."<sup>20</sup> 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.<sup>21</sup> Thus, the First and Ninth Circuits both permitted a surcharge of exemptions, while the Tenth Circuit did not,<sup>22</sup> thereby creating a division in the circuit courts that the Supreme Court agreed to resolve.<sup>23</sup>

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).<sup>24</sup> 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.<sup>25</sup> 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.<sup>26</sup>

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

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.<sup>27</sup> 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*<sup>28</sup> is a prime example. In this case, the debtors filed a chapter 13 petition shortly after losing their home in foreclosure proceedings,<sup>29</sup> and the case was subsequently converted to chapter 7. At no point during the bankruptcy proceedings did the debtors list any legal claims relating to the foreclosure sale.<sup>30</sup> 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.<sup>31</sup> 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 wildcard exemptions of \$5,300 in each.<sup>32</sup> The trustee objected to the claimed exemptions on bad-faith and inequitable-conduct grounds.<sup>33</sup>

In the meantime, the trustee negotiated a settlement of the wrongful foreclosure claims, which was approved by the bankruptcy court.<sup>34</sup> 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*.<sup>35</sup>

12. *Id.* at 2696.  
 13. *See, e.g., In re Messay*, 495 B.R. 729 (B.A.P. 1st Cir. 2012).  
 14. *See in re Gregory*, 492 B.R. 444 (Bankr. E.D.N.C. 2013).  
 15. *Law*, 134 S. Ct. at 1195.  
 16. *Id.*  
 17. *Id.* at 1194.  
 18. *Id.*  
 19. *See* 2008 WL 7751415 (B.A.P. 9th Cir. 2008).  
 20. *In re Law*, 435 Fed. App'x. 647, 648 (2011) (per curiam).  
 21. *Mattley v. Agos*, 643 F.3d 25 (1st Cir. 2012).  
 22. *See in re Schkone*, 535 F.3d 1258 (10th Cir. 2008).  
 23. *Stephen Law v. Alfred H. Siegel*, Chapter 7 Petition, 435 Fed. App'x. 997 (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. 909 (E.D. Mich. 2014).  
 29. *Id.* at 850, 932.  
 30. *Id.*  
 31. *Id.*  
 32. *Id.*  
 33. *Id.*  
 34. *Id.*  
 35. *Id.*

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## Trustee Talk: Law v. Siegel Dicta Leads Lower Courts Astray

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The bankruptcy court reached a similar result in *In re Arellano*.<sup>36</sup> In this case, the trustee determined at the meeting of creditors that the debtor had an unsecured bank balance of \$4,958.65 and an anticipated tax refund of \$2,000.<sup>37</sup> The debtor proceeded to amend his Schedules B and C to list the omitted assets and claim them as exempt,<sup>38</sup> 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.”<sup>39</sup>

Most recently, in *Gray v. Warfield (In re Gray)*,<sup>40</sup> 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.<sup>41</sup> 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.<sup>42</sup> 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.”<sup>43</sup> The BAP reached this conclusion notwithstanding its explicit recognition that the Supreme Court’s discussion on this point was non-binding *dicta*.<sup>44</sup>

### 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.”<sup>45</sup> 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.<sup>46</sup> 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.<sup>46</sup>

### 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](#)

36 517 B.R. 229 (Bankr. S.D. Cal. 2014).  
37 *Id.* at 229, 228.  
38 *Id.*

39 *Id.* at 232.

40 2014 Bankr. LEXIS 4074 (B.A.P. 9th Cir. Dec. 9, 2014).

41 *Id.* at \*2.

42 *Id.* at \*5-8.

43 *Id.* at \*6.

44 *Id.* at \*7.

45 The Supreme Court has explained that the Bankruptcy Code does not contain long-held pre-Code practices absent clear language to the contrary. See *Dunlap v. News*, 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).

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**HISTORY OF STEPHEN LAW CASE AND DEBTOR'S MISCONDUCT**

By Steven T. Gubner, Esq.

**A. The Bankruptcy Case and Fraud Adversary Proceeding.**

The Bankruptcy Case was initiated by the filing of a voluntary chapter 7 petition on January 5, 2004 (the "Petition Date"). Debtor owned the Property on the Petition Date, and claimed a homestead exemption in the Property in the amount of \$75,000. Alfred H. Siegel was duly appointed as the Chapter 7 Trustee.

In his schedules, the Debtor testified that he made, executed and delivered to Lili Lin of Artesia (as hereinafter further identified) a Promissory Note dated June 24, 1999 for the principal sum of \$168,000.00 (the "Note"), and for no consideration to secure the obligations contained in the Note, the Debtor made, executed and delivered to Lili Lin of Artesia a Deed of Trust and Assignment of Rents, dated June 24, 1999, and recorded on or about June 28, 1999 with the Los Angeles County Recorder as Document No. 99-1179298 (the "Disputed Trust Deed"). Pursuant to the Disputed Trust Deed, the Debtor, as trustor, irrevocably granted, transferred, and assigned, to Lili Lin of Artesia, as trustee and beneficiary, his valuable interest in the Property, with power of sale (the "Transfer"); On June 8, 2004 the Trustee filed a complaint (the "Fraud Complaint") against Lili Lin, an individual ("Lin") initiating the Fraud Adversary Proceeding, *Siegel v. Lin (In re Law)*, Adv. No. 2:04-ap-01969, in the Bankruptcy Case. The Fraud Complaint sought to avoid and recover the Disputed Trust Deed from Lin.

Debtor made, executed and delivered a copy of the Note to Lin; to encumber the Property and to allegedly secure the obligations contained in the Note, Debtor allegedly made, executed and delivered the Disputed Trust Deed to Lin, as trustee and beneficiary. At the time of the recordation of this "comfort lien" in favor of Lin, a state court action styled *Cau-Min Li v. Law*, LASC Case No. KC 025668 was pending against the Debtor, and a judgment in the amount of \$131,821.74 was subsequently entered against Debtor on October 14, 1999 ("State Court Judgment"). The State Court Judgment was entered within four months of the recording of the

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Disputed Trust Deed. The State Court Judgment included a finding that Debtor's "acts and conduct merit reaffirmation as a vexatious litigant, from August 25, 1995, as of July 8, 1999."

Debtor listed the Disputed Trust Deed in his Schedules. The Trustee alleged in the Fraud Complaint that the Disputed Trust Deed was fictitious and fraudulent, and that the Transfer was undertaken by Debtor to falsely encumber the Property with the intent to defraud his creditors.

Thereafter an answer to the Fraud Complaint was filed by Lili Lin (of Artesia), and she eventually entered into a stipulated judgment ("Stipulated Judgment") with the Trustee stating that although she was listed as a beneficiary of the Disputed Trust Deed, she had not loaned Debtor money as set forth in the Note and Disputed Trust Deed, and that in or about June 1999 Debtor gave her a copy of the Disputed Trust Deed and Note but never explained to her why he gave her the documents. The Stipulated Judgment found that the Transfer was made by Debtor with the actual intent to hinder, delay, or defraud his creditors. By the Stipulated Judgment the Trustee and Lin resolved all of their differences with respect to the Fraud Adversary Proceeding.

On April 19, 2005, the Trustee filed his Notice of Motion and Motion to Approve Compromise of Controversy ("9019 Motion") requesting the issuance of an order approving the Stipulated Judgment. A hearing on the 9019 Motion took place on May 18, 2005.

Upon a review of the 9019 Motion, the oppositions filed by Debtor and Lili Lin of China, and the oral argument of counsel and Debtor, the Court found that Lili Lin (of Artesia): (1) presented evidence that demonstrated to the Court that she had a direct interest in the matter at issue, (2) was directly involved with the Disputed Trust Deed at issue, and (3) proved by her declaration (the "Lili Lin (of Artesia) Declaration") that in the year 2000, Debtor gave her a series of documents, which she rejected, by which Debtor requested that she assign her interest in the Note to Connie Chang, Debtor's ex-wife, substitute County Records Research as the Trustee under the Disputed Trust Deed, foreclose on the Property, and sell the Property to satisfy the obligations secured by the Disputed Trust Deed. At the hearing on the 9019 Motion the Court stated: "[B]ased on what you've been telling me, Mr. Law, you know the woman [Lili Lin] in China. Mr. Chow [Lili Lin of China's attorney] knows the woman [Lili Lin] in China.

I'm sure that one or both of you could bring her forward or bring evidence forward if you wanted to do that. You haven't done it."

Despite the oppositions filed by the Debtor and ostensibly by a person who came to be known as Lili Lin of China, the Court found that the Trustee's evidence provided good cause to grant the 9019 Motion and approve the Stipulated Judgment, finding it was fair and equitable and in the best interests of the Estate. The order approving the 9019 Motion was affirmed by the BAP on July 10, 2007.

Pursuant to the Stipulated Judgment entered by the Court, it was determined that: (1) Debtor then owned the Property; (2) the Debtor for no consideration executed and caused the Note in the principle sum of \$168,000.00 and the Disputed Deed of Trust to be recorded; (3) Debtor, as trustor, granted to Lili Lin (identified by her signature on the Stipulated Judgment as Lili Lin (of Artesia)) as trustee and beneficiary Debtor's valuable interest in the Property (*i.e.* the "Transfer"); (4) the Transfer was made by Debtor with the actual intent to hinder, delay or defraud Debtor's creditors; (5) the Transfer was avoided pursuant to 11 U.S.C. § 544(b) and Cal. Civ. Code § 3439.04(a), and (6) the Disputed Trust Deed and Note were recovered and assigned to the Trustee pursuant to Section 550(a) and preserved for the benefit of the Estate under Section 551.

Thereafter, on May 31, 2005, an answer to the Fraud Complaint was filed by Lili Lin of China, *pro se*. (Lili Lin of China was represented previously by Peter Chow, Esq. and no substitution of attorney was ever filed.) In addition to filing an answer, Lili Lin of China filed a Motion for Reconsideration of the Order approving the 9019 Motion ("Reconsideration Motion"). The Reconsideration Motion provided no evidence that Debtor ever received consideration from Lili Lin of China for the Note and Disputed Trust Deed, no evidence that Debtor made monthly payments to Lili Lin of China in accordance therewith, and no explanation as to why Debtor tried to foreclose on the Property.

A hearing on the Reconsideration Motion took place on July 6, 2005. Lili Lin of China did not appear at the hearing and the Reconsideration Motion was denied. Lili Lin of China also

filed numerous subsequent pleadings and declarations in the Fraud Adversary Proceeding yet never physically appeared at the Bankruptcy Court. Accordingly, Lili Lin of China had ample opportunities to “make her case,” assert her interest in the Property, and/or assert any defenses to the Fraud Complaint, but failed to do so.

**B. Sale of the Property.**

On July 8, 2005 the Trustee filed a Motion for Turnover (“Turnover Motion”) of the Property. The Turnover Motion was granted. On or about August 19, 2005, Debtor filed Emergency Motions for Stay of the Turnover Order Pending Appeal with both the BAP and the Ninth Circuit. Both motions were denied.

On or about January 9, 2006, the Trustee filed a motion to approve the sale of the Property (the “Sale Motion”). A hearing on the Sale Motion took place on February 1, 2006 and an auction to purchase the Property was conducted. The highest and best offer to purchase the Property was \$680,000.00 and the Sale Motion was granted.

Escrow on the sale of the Property closed on March 9, 2006. Thereafter, on February 24, 2006, Debtor and Lili Lin of China filed a motion for reconsideration of the Sale Order or for stay pending appeal (the “Sale Reconsideration Motion”). The Court denied the Sale Reconsideration Motion and Debtor’s oral motion for a stay pending appeal also was denied. Again, Lili Lin of China again failed to appear at the hearing on the Sale Reconsideration Motion.

**C. The Perjury Issue**

Debtor perjured himself twice in the Bankruptcy Court by filing fraudulent documents under oath. First, Debtor perjured himself by knowingly and fraudulently making a false oath or account to the Bankruptcy Court when he listed the Disputed Trust Deed in his bankruptcy schedules. Debtor again perjured himself to the Bankruptcy Court when he knowingly and fraudulently attached a fake promissory note as Exhibit F to his Sale Reconsideration Motion. The Sale Reconsideration Motion claimed that the note was recorded with the Los Angeles County Recorder Office as document number 99-1179298. The Trustee obtained a certified

copy of the recorded Note from the Los Angeles County Recorder Office which evidenced the fact that the note attached to the Sale Reconsideration Motion was never recorded.

**D. Adversary Proceeding Re Debtor's Discharge**

1. The Trustee Substitutes as Plaintiff in Discharge Action

On April 12, 2004, plaintiffs Shong-Ching Tong, Yei Hwei Tong, Cau-Min Li, and the Estate of Robert Shucker filed an adversary complaint against Debtor to determine the dischargeability of a debt (the "First Dischargeability Action") and to object to the granting of a discharge to Debtor (the "First Dischargeability Complaint"). On April 8, 2004, plaintiffs Cau-Min Li and U.S. Judgment Enforcement Agency filed a separate adversary complaint against the Debtor to determine dischargeability of a debt (the "Second Dischargeability Action") and to object to the granting of a discharge to the Debtor (the "Second Dischargeability Complaint").

The Trustee substituted in as Plaintiff in the First Dischargeability Action and in the Second Dischargeability Action. The First and Second Dischargeability Actions were consolidated on November 15, 2004 (the "Consolidated Dischargeability Action").

The First and Second Dischargeability Complaints were rewritten to make clear that a denial of discharge was sought because the Debtor knowingly and fraudulently made a false oath or account by listing in his Schedule D a fictitious trust deed as an encumbrance on the Property. On June 8, 2004, the Trustee filed the Fraud Complaint (discussed above).

2. The Discovery Dispute

On October 26, 2004, the Trustee served Debtor with Interrogatories, Request for Admissions, and Request for Production of Documents (hereinafter collectively "Discovery"). After an extension of time, on December 29, 2004, Debtor served incomplete responses.

Trustee's counsel and Debtor met and conferred and Trustee's counsel sent Debtor a Stipulation Regarding Discovery Dispute ("Stipulation"). Trustee's counsel also requested that Debtor prepare his contentions to the Stipulation but Debtor failed to respond and the Trustee brought a motion to compel responses from the Debtor (the "Motion to Compel").

3. Motion to Compel.

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The Court granted the Trustee's Motion to Compel, and made the following findings: (i) the Debtor did not cooperate with the Trustee to resolve this discovery dispute as required by Loc. Bankr. R. 9013-1(c); (ii) Debtor's written discovery responses were obstinate and evasive; (iii) the opposition that the Debtor filed to the Motion to Compel was not substantially justified; and (iv) the circumstances justified an award of sanctions against the Debtor in the amount of \$3,520. The sanctions awarded to the Trustee remain unpaid by the Debtor.

Thereafter, on May 18, 2005 at a hearing in the Consolidated Dischargeability Action, the Trustee stated that he had not received the discovery responses as required by the Discovery Order. Debtor responded that an appeal regarding the Discovery Order was pending and the Court advised Debtor that an appeal would not have an effect on his duties to furnish information.

On May 27, 2005, after the Debtor failed to provide the Trustee with discovery responses, or pay monetary sanctions in compliance with the Discovery Order, the Trustee filed his Motion to Strike Debtor's Answer ("Motion to Strike-Dischargeability") on the grounds that Debtor has intentionally and willfully abused the judicial process by: (1) failing to comply with discovery over a period of eight months from October 24, 2004 to June 2005, (2) failing to comply with all parts of the Discovery Order, and (3) acting in direct contravention of this Court's oral directives. On August 10, 2005, the Court granted the Motion to Strike. Debtor of course appealed to the BAP, which affirmed the Bankruptcy Court and Debtor appealed to the Ninth Circuit.

Eventually, on September 27, 2005, the Court denied the Debtor's discharge via default judgment, pursuant to section 727(a)(4)(A), for making false oaths or accounts as described above. Case No. 04-1666; 04-1672. On or about December 29, 2006, the BAP affirmed the denial of the Debtor's discharge.

### **E. The Declaratory Relief Action**

Turning back to issues regarding the Disputed Trust Deed, and the disputes between the Debtor, Trustee, and Lili Lin, on February 8, 2007, as instructed by the BAP in its December 29,

2006 Memorandum of Decision, the Trustee filed an adversary complaint (“Declaratory Relief Complaint”) titled *Alfred Siegel vs. Lili Lin, an individual*,\_Adv. No. 1:07-ap-01102 (the “Declaratory Relief Action”) to determine whether Lili Lin of China had any rights with respect to the Disputed Trust Deed. As a result of the Declaratory Relief Action, Debtor created a confluence in the paths of the various adversary proceedings and appeals and a perfect storm of obfuscation.

The sole reason the Trustee filed the Declaratory Relief Action was because the BAP determined that there had not been an adequate judicial determination that Lili Lin of China did not have a lien against the Property and that if the Trustee continued to contest the lien status of Lili Lin of China it was incumbent upon the Trustee to obtain an appropriate judicial determination eliminating her interest. It is important to note that not only did the BAP instruct the Trustee to seek a judicial determination regarding Lili Lin of China, but the BAP was very clear that any pleadings relating to a judicial determination regarding Lili Lin of China were to be served upon her attorney of record, Andrew Smyth, who appeared before the BAP and stated that he would accept service.

On February 9, 2007, a summons was issued in the Declaratory Relief Proceeding, and on or about February 23, 2007 Mr. Smyth, as attorney of record for Lili Lin of China, accepted service of the Summons and Complaint on behalf of Lili Lin of China and executed an Acknowledgment of Receipt thereof. On March 5, 2007, Mr. Smyth filed an Answer on behalf of Lili Lin of China as the “Attorneys for Debtors.” Mr. Smyth also filed and served an identical Answer on March 9, 2007.

On April 17, 2007, a Motion for Judgment on the Pleadings was filed purportedly by Lili Lin of China. The basis of this motion was that the Declaratory Relief Action was essentially the same as the Fraud Adversary Proceeding and therefore was time barred because it was an action to set aside the Transfer. Then on May 29, 2007, Lili Lin of China purportedly filed a Motion to Dismiss the Complaint for Declaratory Relief.

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In this motion, Lili Lin of China argued that the judgment in the Fraud Adversary Proceeding “terminated any rights Lili Lin may have had in the property at 16150 La Monde St., Hacienda Heights, CA 91745, or in any trust deed on that property.” This is exactly the opposite of what the BAP in fact ruled. The absurdity of Lili Lin of China’s position is manifest. It had already been determined that her interest in the Property, if any, had not been adjudicated and when the Trustee commenced the Declaratory Relief Action to provide a mechanism for a determination of her interest and, rather than availing herself of the opportunity for vindication, Lili Lin of China sought to terminate the Declaratory Relief Proceeding. The absurdity of this position is enhanced by the fact that even if Lili Lin of China succeeds in her appeal of the judgment in the Fraud Adversary Proceeding the result will be at best that she will have the chance to validate her claim in that action at some date in the future when she could have accomplished the same thing in the Declaratory Relief Action. This analysis of the contradictory and absurd arguments supposedly being made by Lili Lin of China (but then perhaps not since the Court recently ruled that the Declaratory Relief Action should be dismissed for lack of proof that Lili Lin of China has actually appeared (despite an Answer having been filed), demonstrated that it is the Debtor who was actually orchestrating this silly symphony solely to dissipate the estate and punish the Trustee and his counsel by abusing the judicial system.

The inference to be drawn from this set of facts was that Lili Lin of China had no evidence that she has an interest in the Property and that this charade was being staged by and for the benefit of Debtor in order to exhaust the assets of the estate to the detriment of his creditors or to force the Trustee to reach a settlement with him.

On June 1, 2007, the Trustee filed a Motion to Strike the Answer filed by Mr. Smyth for Lili Lin of China (“Motion to Strike-Lili Lin”) and a Motion for Sanctions. On June 12, 2007, Mr. Smyth filed an Opposition to Motion for Sanctions. In his declaration in support of that opposition, Mr. Smyth stated that he was the attorney for Lili Lin of China, that he was told by Debtor Stephen Law that Lili Lin was hiring him, and that Connie Chang (Debtor’s ex-wife) gave his office the money for his fee.

Debtor also filed a Declaration and Objections to the Trustee's Motion for Sanctions. Attached to that declaration are e-mails in Chinese which Debtor claims had been sent by Lili Lin of China and which he translated into English. One of the e-mails (as translated by Mr. Law) purportedly states that Lili Lin of China retained Mr. Smyth as her attorney in 2005 but she had not met him.

The Trustee noticed Lili Lin of China's deposition for July 26, 2007. On July 25, 2007, Mr. Smyth notified the Trustee's counsel that his client would not be appearing.

On August 17, 2007, the Court granted the Motion to Strike-Lili Lin, striking Lili Lin of China's Answer in its entirety, and denied Lili Lin of China's Motion to Dismiss, and on August 27, 2007 Lili Lin of China filed a Notice of Appeal of the order granting the Motion to Strike-Lili Lin. On October 4, 2007 the Clerk of the BAP issued an Order requiring Appellants to show cause why the appeal should not be dismissed for lack of jurisdiction (the "BAP Clerk's Order"). A Response by Lili Lin and Stephen Law to the BAP Clerk's Order was served on the Trustee on October 16, 2007.

Also, on August 27, 2007, Lili Lin of China "filed" her answer *pro se* in the Declaratory Relief Action and asserted as an affirmative defense that Mr. Smyth was not her attorney in the Bankruptcy Court. In that Answer, Lili Lin of China again listed her address is 2345 Los Padres Dr., Rowland Heights, California. However, in that same case in Responses to Plaintiff's Interrogatories ("Responses"), Lili Lin of China stated that she has never lived in the United States but provided a Post Office Box in the City of Industry, California as her mailing address in the United States. These Responses purportedly were verified in China by Lili Lin of China on May 10, 2007 and then were served by her attorney of record, Andrew Smyth.

On September 11, 2007, the Trustee filed a Motion for Default Judgment against Lili Lin of China.

On October 1, 2007, the Court entered its "(1) Order to Appear Personally, (2) Order to Show Cause, (3) Briefing Order, and (4) Notice of Status Conference" (the "Court Order"), ordering Lili Lin of China to personally appear and bring with her identification and documents

to support her claimed interest in the Property and further ordered Lili Lin of China to show cause why the Answer filed on August 27, 2007 should not be stricken. The Court also ordered Trustee's counsel to brief the issue of the adequacy of service on Lili Lin of China.

On October 24, 2007 the Court entered orders denying the Trustee's Request for Entry of Default and the Trustee's Motion for Default Judgment. Notwithstanding that Lili Lin of China through her attorney of record had filed two Answers and numerous pleadings in the Declaratory Relief Proceeding, and had herself purportedly filed an Answer and several other pleadings, the Court decided that service of the Declaratory Relief Complaint was defective and the Court had no jurisdiction over Lili Lin of China.

On November 14, 2007, the Court continued the hearing on the Order to Show Cause to January 30, 2008. On January 30, 2008, attorney Peter Chow filed a Substitution of Attorney substituting in place of Lili Lin of China and Andrew Smyth filed a Status Report stating that he did not represent anyone in the Bankruptcy Case. At the hearing on January 30, 2008, Mr. Chow represented to the Court that he had met with Lili Lin of China in Hong Kong in December 2007, that he represented her and that he had copies of documents, including a copy of the Disputed Trust Deed. Mr. Chow requested a continuance because of his recent engagement and the Bankruptcy Court continued the hearing on the Order to Show Cause to April 3, 2008. On March 3, 2008, Mr. Chow served Lili Lin of China's Response to Order to Show Cause.

The Response consisted of documents that were submitted previously by "Lili Lin of China" and/or her then attorney Andrew Smyth and/or Debtor - including:

1. A photocopy of an Identification Card for a Lili Lin issued by the People's Republic of China -- previously submitted (a) by Debtor on February 24, 2006 as an exhibit to the Sale Reconsideration Motion, and (b) by Lili Lin of China in response to the Trustee's Request for Production of Documents in the Declaratory Relief Action (the "Request for Production").

2. Photocopies of bank statements for Debtor's account at Cal Fed -- previously submitted (a) by Debtor on February 24, 2006 as an exhibit to the Sale Reconsideration Motion and (b) by Lili Lin of China in response to the Request for Production.

3. Photocopies of bank statements for an account in China for a Lili Lin -- previously submitted by Debtor on February 24, 2006 as an exhibit to the Sale Reconsideration Motion, and (b) by Lili Lin of China in response to the Request for Production.

4. Photocopies of 12 "receipts" that purport to be for payments on the Note -- previously submitted (a) by Debtor on February 24, 2006 as an exhibit to the Sale Reconsideration Motion and (b) by Lili Lin of China in response to the Request for Production.

5. A photocopy of an unrecorded promissory note dated June 24, 1999 in the sum of \$168,000.00 with Lili Lin as the promisee and showing "(DOB 22Nov1947)," the same phony promissory note that Debtor had attached as an exhibit to a pleading he filed -- previously submitted (a) by Debtor on February 24, 2006 as an exhibit to the Sale Reconsideration Motion and (b) by Lili Lin of China in response to the Request for Production.

6. A photocopy of the recorded Disputed Trust Deed and Note also dated June 24, 1999, but without the "DOB."

Notwithstanding Debtor's assertions in various failed pleadings he had filed that these documents and declarations conclusively established that Lili Lin of China is the real beneficiary of the Disputed Trust Deed, they had absolutely no probative value.

Finally, it appeared that the Debtor became fatally entangled in his own web of deceit and lies. On February 11, 2004 at the Meeting of Creditors conducted by the Trustee (the "Meeting of Creditors"), the Debtor stated under oath that the \$168,000.00 he claimed to have received from Lili Lin was not deposited in a bank account but rather was paid directly to creditors and that he had receipts.

On April 3, 2008 the Court vacated all answers in the Declaratory Relief Action and dismissed the Declaratory Relief Complaint without prejudice. The Court stated on the record that the basis for vacating the answers and dismissing the complaint was that the Court was not

persuaded that Lili Lin of China had been served and submitted to the jurisdiction of the Court, notwithstanding her appearance through counsel and in *pro per*. Mr. Chow then stated to the Bankruptcy Court that he was not authorized to accept service for his client. If this sounds familiar it is identical to Mr. Smyth's "now I represent Lili Lin, now I don't" shuffle.

This bizarre set of facts begs the question that if there truly is a Lili Lin of China with a valid interest in the Property, who obviously is aware of the Declaratory Relief Proceeding, why has she never appeared and presented her evidence? She has been given every opportunity to do so. The answer would seem apparent: Lili Lin of China either does not exist or if she exists has no evidence that she has an interest in the Property, and in either event this entire ruse was concocted by Debtor and is a blatant abuse of the judicial process.

Ultimately, the Court agreed with the Trustee that Lili Lin of China was not a real person that held a deed on the Property, and the Court specifically found that:

Had Debtor not made up this loan and persisted in his misrepresentations to Trustee and the court, ample funds would have been available to pay Debtor's creditors and Trustee's costs. Had the sale of Debtor's home proceeded in an orderly way, absent the disputes concerning Lili Lin of China's interest in the property, Debtor almost certainly would have received surplus funds from this bankruptcy estate in excess of his claimed homestead exemption. As a result of the dispute over the disputed deed of trust, however, Trustee has incurred more than \$500,000 in attorneys' fees, and it is unlikely that any funds will be available for creditors.

401 B.R. 447, 453 (Bankr. C.D. Cal. 2009), *rev'd on other grounds*, 571 U.S. \_\_\_, 134 S. Ct. 1188 (2014). In short, this Court found that the Debtor fabricated the existence of a lien on his property in order to preserve his Homestead Exemption, and went to great lengths to substantiate this false lien.

The Court authorized the Trustee to surcharge the Debtor's homestead exemption to pay administrative professionals, which, as everyone now knows, was ultimately reversed by the U.S. Supreme Court in *Law v. Siegel*, 571 U.S. \_\_\_, 134 S. Ct. 1188 (2014).